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IN THE

Supreme Court of the United States

OCTOBER TERM, 1995

WERNER H. ERHARD,

Petitioner,

-against-

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Is the requirement of I.R.C. § 7443A(b)(4), that only a Tax Court judge and not a special trial judge may decide a case assigned to the special trial judge for hearing and report, satisfied (1) when the Tax Court judge adopts the special trial judge's lengthy report verbatim, (2) when there is no opportunity for a party to make oral or written objections to the special trial judge's report, and (3) when the applicable Tax Court rule presumes that the decision of a special trial judge is correct?

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PETITION FOR A WRIT OF CERTIORARI

Petitioner, Werner H. Erhard, prays that a writ of *certiorari* issue to review a judgment of the United States Court of Appeals for the Ninth Circuit affirming a judgment of the United States Tax Court.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Ninth Circuit is reported at 46 F.3d 1470 (1995), and is reprinted at Appendix B, page 3a.[1] The initial memorandum opinion of the United States Tax Court is unofficially reported at 62 T.C.M. (CCH) 1 (1991), and is reprinted at Appendix F, page 49a. The supplemental memorandum opinion of the

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[1]All page references of the form "__a" are to the Appendices to this petition.

Tax Court, which was issued pursuant to Petitioner's Motion for Reconsideration, is unofficially reported at 64 T.C.M. (CCH) 10 (1992), and is reprinted at Appendix E, page 35a. The second supplemental memorandum opinion of the Tax Court, which was issued pursuant to the parties' computations for entry of decision submitted to the Tax Court, is unofficially reported at 65 T.C.M. (CCH) 1786 (1993), and is reprinted at Appendix D, page 30a.

JURISDICTION

The decision of the Court of Appeals below was entered on February 8, 1995 (Appendix B, page 3a). On April 25, 1995, the Court of Appeals denied a timely petition for rehearing (Appendix A, page 1a). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTES AND RULES

Section 7443A(a), (b) and (c) of the Internal Revenue Code:

(a) **Appointment.**—The chief judge may, from time to time, appoint special trial judges who shall proceed under such rules and regulations as may be promulgated by the Tax Court.

(b) **Proceedings Which May be Assigned to Special Trial Judges.**—The chief judge may assign—

(1) any declaratory judgment proceeding,

(2) any proceeding under section 7463,

(3) any proceeding where neither the amount of the deficiency placed in dispute (within the meaning of section 7463) nor the amount of any

claimed overpayment exceeds $10,000, and

(4) any other proceeding which the chief judge may designate, to be heard by the special trial judges of the court.

(c) **Authority to Make Court Decisions.**—The court may authorize a special trial judge to make the decision of the court with respect to any proceeding described in paragraph (1), (2), or (3) of subsection (b), subject to such conditions and review as the court may provide.

Tax Court Rules of Practice & Procedure, Rule 183:

RULE 183. Cases Involving More Than $10,000. Except in cases subject to the provisions of Rule 182 or as otherwise provided, the following procedure shall be observed in cases tried before a Special Trial Judge:

(a) **Trial and Briefs:** A Special Trial Judge shall conduct the trial of any such case assigned for such purpose. After such trial, the parties shall submit their briefs in accordance with the provisions of Rule 151. Unless otherwise directed, no further briefs shall be filed.

(b) **Special Trial Judge's Report:** After all the briefs have been filed by all the parties or the time for doing so has expired, the Special Trial Judge shall submit a report, including findings of fact and opinion, to the Chief Judge, and the Chief Judge will assign the case to a Judge or Division of the Court.

(c) **Action on the Report:** The Judge to whom or the Division to which the case is assigned may

> adopt the Special Trial Judge's report or may modify it or may reject it in whole or in part, or may direct the filing of additional briefs or may receive further evidence or may direct oral argument, or may recommit the report with instructions. Due regard shall be given to the circumstance that the Special Trial Judge had the opportunity to evaluate the credibility of witnesses, and the findings of fact recommended by the Special Trial Judge shall be presumed to be correct.

STATEMENT OF THE CASE

The United States Tax Court is comprised of 19 judges appointed by the President for 15-year terms with the advice and consent of the Senate. I.R.C. § 7443. There are currently 14 special trial judges, more than two-thirds of the total number of Tax Court judges, who are appointed by the chief judge of the Tax Court. I.R.C. § 7443A(a).

The chief judge is authorized to assign four categories of cases to a special trial judge. I.R.C. § 7443A(b). In the first three categories of cases, subject to such conditions and review as the Tax Court may provide, the special trial judge has the authority to make the decision of the Tax Court. In the fourth category, the chief judge may assign to a special trial judge "any other proceeding that the chief judge may designate." I.R.C. § 7443A(b)(4). However, in this fourth category, the chief judge may authorize the special trial judge "only to hear the case and prepare proposed findings and an opinion. The actual decision then is rendered by a regular judge of the Tax Court." *Freytag v. Commissioner*, 501 U.S. 868, 874 (1991). In *Freytag*, this Court concluded that pursuant to I.R.C. § 7443A(b)(4), the chief judge may "assign *any* Tax

Court proceeding, regardless of complexity or amount, to a special trial judge for hearing and the preparation of proposed findings and written opinion," and confirmed that the special trial judge has no authority actually to decide the case. *Id.* at 877 (emphasis added).

Rule 183(c) of the Tax Court's Rules of Practice and Procedure requires the Tax Court judge to give "due regard" to the fact that the special trial judge "had the opportunity to evaluate the credibility of witnesses," and states that the findings of fact recommended by the special trial judge are "presumed to be correct." Moreover, Rule 183(b) provides that following post-trial briefs from the parties, the special trial judge "shall submit a report, including findings of fact and opinion to the Chief Judge, and the Chief Judge will assign the case to a Judge or Division of the Court." The report is not served on the parties, and the rule does not require that a party have an opportunity to be heard on objections to the report before it is acted on by the Tax Court judge.

At issue in this case is whether the statutory obligation of the Tax Court judge to make the decision of the Tax Court (and the prohibition of the special trial judge from making the decision of the court) is satisfied when under Tax Court Rule 183 the Tax Court judge must review the findings of fact of the special trial judge under a highly deferential standard, and parties are not given an opportunity to object and be heard on objections to the report before the judge acts on it.

Petitioner's case involved the determination of whether his purchase of the operating assets of a multi-million dollar, multinational educational training business and certain other assets from a separate corporate taxpayer, est, a.e.c., had economic substance for tax purposes, or whether it was a sham transaction. Erhard petitioned the U.S. Tax Court for a

redetermination of the deficiencies determined by the IRS for the years 1981, 1982 and 1983. Initially, the cases were assigned to a judge of the Tax Court. Then, without notice to Erhard and over Erhard's objection, the chief judge assigned the cases to a special trial judge for trial.[2] Erhard objected to the assignment to the special trial judge for two reasons: (1) there were disputed issues of fact which, because of the deferential standard of review accorded a special trial judge's findings, would likely become the findings of the court, and (2) the special trial judge assigned to the case might be improperly influenced by previous cases he had tried involving est, a.e.c. (not Erhard) and its controversial tax advisor, Harry Margolis. The chief judge advised the special trial judge of Erhard's objections, and after the special trial judge orally assured the chief judge of his objectivity, the chief judge denied the objections on the basis of this assurance.

Before his case was tried by the special trial judge, Erhard pressed his objections to the assignment by petitioning the Court of Appeals for the Ninth Circuit for a writ of mandamus directing the chief judge of the Tax Court to assign the case to a Tax Court judge. Erhard again pointed out the prejudice to him that would result if his case were tried by a special trial judge because of his partiality, and because under Tax Court Rule 183(c)'s deferential standard of review, the decision of the Tax Court would effectively be made by the special trial judge, not by the Tax Court judge. The Ninth Circuit denied the petition "for failure to show damage not correctable on appeal and for failure to show that tax court [sic] clearly erred as a matter of law." (Appendix H, page 122a).

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[2]This case is unlike *Freytag* where the taxpayer did not object to the assignment of the case to the special trial judge for trial.

The trial before the special trial judge lasted six weeks in three sessions beginning on November 1, 1988 and ending February 3, 1989. Petitioner presented 21 witnesses, including legal advisors, the executives of the business operations, and an Arthur Young partner, who testified at length about the business purpose and economic substance of the acquisition by petitioner, as well as four expert witnesses; 721 exhibits were received in evidence. The parties submitted post-trial briefs to the special trial judge on July 6, 1989, October 4, 1989, December 1, 1989, and January 16, 1990. Petitioner's briefs totalled approximately 750 pages. The case was under consideration by the special trial judge until July 1, 1991, approximately 20 months later.

On July 1, 1991, the Tax Court entered an order assigning the case to Tax Court Judge Irene F. Scott for review of the special trial judge's report. Judge Scott filed an opinion that same day adopting the special trial judge's 87 page report, T.C. Memo 1991-290, Appendix F, page 49a. Judge Scott had observed none of the trial, nor had she read the 27 volumes of trial transcript and the 721 exhibits. Without serving the parties with a copy of the report or giving Erhard the opportunity to file objections to the report, the judge adopted the special trial judge's report verbatim as the decision of the Tax Court.

The report of the special trial judge recommended disallowing all depreciation claimed by Erhard on the business properties purchased and all interest deductions accrued and paid on the financing of the transaction. Under Tax Court Rule 183, not only did Erhard have no opportunity to take exceptions to the report of the special trial judge before Judge Scott adopted the report, Judge Scott deferred to the special trial judge's findings of fact and reviewed them under a clearly erroneous standard that required her to "presume that the

special trial judge's findings of fact are correct." *See* 46 F.3d at 1476, Appendix B, at page 16a.

On September 3, 1991, Erhard filed a motion for reconsideration on two legal issues. He contended that, even assuming the correctness of the sham determination, the Tax Court erred in denying him any depreciation on the purchased assets or any deductions for interest actually paid on the disputed loans, and in upholding the substantial understatement of tax penalty and tax-motivated interest. On September 3, 1991, Judge Scott held a hearing on Erhard's motion for reconsideration. At the hearing, Judge Scott stated that she had been sent the case five to six weeks before the order assigning the case to her was filed, and that she had conferred with the special trial judge about the case. The judge stated that she had not read the entire record. During the course of the hearing, the judge admitted:

> Then I discussed [the case with Special Trial Judge Gussis] and I won't pretend I read all of these exhibits. I didn't ...

Excerpts of Record on Appeal, p. 797.

> I want to hasten to tell you that I relied on what Judge Gussis said about credibility...

Excerpts of Record on Appeal, p. 799.

> ... I don't pretend to have read every one of these exhibits or this whole transcript...

Excerpts of Record on Appeal, p. 800.

> ... *my review of the record, and I grant you, it is not as extensive as if I, personally had heard it.* I did rely on the Special Trial Judge's findings, although I didn't just take them carte blanche. And I'm certainly not as familiar with the record as either party is.

Excerpts of Record on Appeal, p. 801 (emphasis added).

In a supplemental memorandum opinion filed on July 6, 1992, T.C. Memo. 1992-376, Judge Scott granted Erhard's motion as to the depreciation and substantial understatement issues, holding that Erhard should be allowed depreciation computed as if there had been no sale and that no substantial understatement penalty was due. (Appendix E, page 35a). The issues on which Judge Scott granted Erhard's motion were issues of law rather than fact, and therefore she was required to review them *de novo*, with no presumption of correctness. In the course of her supplemental opinion, Judge Scott remarked that her consideration had not been helped by Erhard's attempt to reargue the case:

> Our attempt to review the record to ascertain what basis, if any, the record supports for these assets in the hands of WEA has not been assisted by petitioners' continuous argument that the sham transactions purportedly purchasing these assets should be recognized and that the values assigned to the assets by petitioners in the returns for 1981, 1982, and 1983 be accepted.

64 T.C.M. (CCH) 10, 11 (1992), Appendix E, page 38a.

Petitioner appealed the Tax Court decision to the Court of Appeals, arguing, *inter alia*, that the case had been effectively decided by the special trial judge, in contravention of I.R.C. § 7443A. The court below held that the Tax Court had not improperly allowed the special trial judge to decide the case. Although Judge Scott had admitted that she had not read every exhibit or the entire transcript, the Court of Appeals found that the judge was required under the Tax Court rules to give due regard to the special trial judge's report on findings of fact and credibility and to review his report under a clear error

standard. Although the petitioner's claim was that Judge Scott had not decided the case, but abdicated this duty to the special trial judge, the Court of Appeals nevertheless upheld the Tax Court's decision on the theory that, since the record was so voluminous, "it was perfectly reasonable for Judge Scott not to read every word." 46 F.3d at 1476, Appendix B, page 17a.

REASONS FOR GRANTING THE WRIT

Certiorari should be granted in order to resolve an important question left undecided four years ago in *Freytag*. That issue was whether "the deferential standard with which Tax Court Rule 183 requires a Tax Court judge to review the factual findings of a special trial judge allows the latter not only to hear a case but effectively to resolve it." *Freytag v. Commissioner*, 501 U.S. 868, 874 n.3 (1991). Tax Court Rule 183 violates I.R.C. § 7443A(b)(4) and this Court's decision in *Freytag* because Tax Court Rule 183 (1) requires the Tax Court judge to defer to a special trial judge's factual findings, and (2) does not give the parties the right to object to the special trial judge's report before the judge acts on it. Since *Freytag*, no court has addressed the issue of whether the deferential standard of Tax Court Rule 183 allows the special trial judge to not only hear but to decide the case. As a result, the decision of the Court of Appeals in this case does not conflict with the decisions of any other court of appeals. Nonetheless, review of this important question is appropriate for the following reasons:

1. The Court should consider this issue because it is an issue of first importance in the administration of the tax laws. Further consideration of the issue through court of appeals review is both unnecessary and will result in uncertainty in procedure in the Tax Court, where taxpayers file approximately 95 percent of all tax cases. In 1994, special trial judges rendered approximately 23% of the Tax Court's published decisions.

They handle not only small cases, but also other cases pursuant to I.R.C. § 7443A(b)(4). These cases constitute approximately 10% of the Tax Court's published decisions in 1994.

2. *Freytag's* requirement that the Tax Court judge decide the case cannot be met if a deferential standard, and certainly not if a clear error standard of review, is used. The opinion of the court below says that, "whichever course [the judge takes under Tax Court Rule 183 with regard to the special trial judge's report], she must presume that the special trial judge's findings of fact are correct, and she must give '[d]ue regard'" to the special trial judge's opportunity to evaluate the credibility of the witnesses (Appendix B, page 16a). The presumptively correct standard of Tax Court Rule 183(c) "sought to establish the relatively high level of deference that the phrase 'clearly erroneous' entails." *Stone v. Commissioner*, 865 F.2d 342, 344 (D.C. Cir. 1989). But a clear error standard of review by the Tax Court judge does not comply with *Freytag's* requirement that the judge make the decision of the Tax Court. *Freytag, supra*, at 874 ("Petitioners appear not to appreciate the distinction between the special trial judges' authority to hear cases and prepare proposed findings and opinions . . . and their lack of authority actually to decide those cases, which is reserved exclusively for judges of the Tax Court.").

The clear error standard "plainly does not entitle a reviewing court to reverse the finding of the trier of fact simply because it is convinced that it would have decided the case differently." *Anderson v. City of Bessemer City*, 470 U.S. 564, 574 (1985). Even if the reviewing court disagrees with the findings, it must accept the trier of fact's determination, provided only that it have some evidentiary support and is a permissible or plausible view of the evidence. 9A Wright & Miller, *Federal Practice & Procedure*, §2585: 572; Christie, *Judicial Review of Findings of Fact*, 87 Nw. U. L. Rev. 14, 44 (1992). By

deferring to the special trial judge's findings under the clearly erroneous standard, therefore, the Tax Court judge could not have substituted her judgment for that of the special trial judge on his factual findings and the conclusions he drew from them.

There is no reason to believe that a special trial judge's findings of fact are entitled to any greater deference on review than those of a magistrate or special master. A complete and careful review of a subordinate judicial officer's report is required to avoid improper "rubber-stamping" of the report by a district court judge. *Burlington N.R.R. Co. v. Department of Revenue*, 934 F.2d 1064, 1072-74 (9th Cir. 1991) (case remanded back to district court, which affirmed the special master's report in a one sentence order, which constituted improper "rubber stamp" of report); *United States v. Wilson*, 864 F.2d 1219, 1222 (5th Cir.) (court remanded case to district court judge because judge did not give "sufficient indication that he made his own determination based upon the record and unrestrained by the findings and conclusions of the magistrate"), *cert. denied*, 492 U.S. 918 (1989); *Reed v. Board of Election Comm'rs*, 459 F.2d 121, 123 (1st Cir. 1972) (when magistrate's findings of fact are approved by a "laying on of hands" by the district court, an "abnegation of judicial authority" has occurred). A deferential standard of review is inconsistent, therefore, with independent decision-making by the judge.

Judge Scott's review was not "adequate" for *Freytag* purposes because *Freytag* assumes that a Tax Court judge will review the special trial judge's report in sufficient depth so that it can fairly be said that the decision of the Tax Court is the judge's decision. In fact, apart from the Circuit Court's observation that Judge Scott followed Rule 183(c)'s deferential standard of review, there is no real indication of what standard Judge Scott actually used in reviewing Special Trial Judge

Judge Gussis's report. The judge only said she did not take the special trial judge's findings "carte blanche," even though she adopted his report verbatim. If Judge Scott did not give the special trial judge full discretionary power, she also did not indicate in what respect she limited that power.

Accordingly, Judge Scott could not and did not give the special trial judge's findings of fact and findings of ultimate fact sufficient review to have made the decision in this case, as she was required to do by I.R.C. §7443A and this Court's opinion in *Freytag*. The Ninth Circuit's conclusion that the judge's review of the special trial judge's report was "adequate" overlooks the requirement of *Freytag* that the Tax Court judge must actually make the court's decision.

Finally, permitting the Tax Court judge to review the findings of fact of the special trial judge under a clear error standard will lead to an unconstitutional result. If the judge of the Tax Court is to review the special trial judge's findings of fact under a clear error standard, review by the judge of the Tax Court is the same as review by a court of appeals.[3] A court of appeals must accept findings of fact of the Tax Court unless there is clear error. *See* I.R.C. § 7482(a). If this same standard applies to the Tax Court judge's review of the special trial judge's report, the effect will be to create a Tax Court trial division comprised of special trial judges and a Tax Court appellate division consisting of the reviewing judges. Nothing in *Freytag* or the Internal Revenue Code authorizes Tax Court supervision of special trial judge findings and opinions in (b)(4) cases to be appellate in nature. These cases are meant to be decided by the Tax Court in the first instance, not merely

[3]Tax Court review may actually compare unfavorably even with review by a court of appeals. At least a court of appeals is briefed on the issues raised by the court below. In a Tax Court proceeding, the parties have no opportunity to file objections to the special trial judge's report.

reviewed after a special trial judge heard the case and drafted the opinion.

3. The Tax Court rules must allow the parties to file objections and the judge must hold a hearing on those objections under procedures similar to those provided in the Federal Rules of Civil Procedure for the district court review of special master and magistrate reports. Anything less is inconsistent with I.R.C. § 7443A and this Court's decision in *Freytag*. The Federal Rules of Civil Procedure are instructive in this case[4] because the referral of a Tax Court case to a special trial judge is similar to the referral of a case by a district court for hearing and report to a magistrate judge or special master. The Tax Court special trial judge is a subordinate judicial officer analogous in status and function to a magistrate judge or a special master. *See Freytag, supra*. The special trial judge prepares a report, including findings of fact, in the same manner as a special master or a magistrate judge. *Compare* Tax Court Rule 183(b) with Fed. R. Civ. P. 53(e)(1) and 28 U.S.C. § 636(b). As is the case with special trial judges, the decision of a district court must be that of the district court judge and not of the magistrate.

Indeed, a special trial judge's findings of fact are subject to the same level of deference given by a district court judge to a special master's report. A special trial judge's findings are "presumed to be correct," and a special master's findings of fact are not to be set aside "unless clearly erroneous." These standards are, in substance, the same. Notes of Advisory Committee on Rules, Note to Subdivision (e). The district court "may adopt the [master's] report or may modify

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[4]Tax Court Rule 1(a) itself provides, "Where in any instance there is no applicable rule of procedure, the Court or the Judge before whom the matter is pending may prescribe the procedure, giving particular weight to the Federal Rules of Civil Procedure to the extent that they are suitably adaptable to govern the matter at hand."

it or may reject it in whole or in part or may recommit it with instructions." Fed. R. Civ. P. 53(e)(2). Tax Court Rule 183(c) gives the Tax Court judge the same discretion.

There is one crucial difference, however, between the review procedures in the district court and those applicable to the Tax Court. After a special master prepares a report, but before the district court acts on it, the report must be served on the parties, who are entitled to file objections. Fed. R. Civ. P. 53(e)(2). If a party files objections, the district court must hold a hearing before ruling on the report. Moreover, the district court may not merely "rubber stamp" the master's report. Rather, the district court must respond to the particular facts of the case and address any objections to the report made by the parties. *See Burlington N.R.R. Co. v. Department of Revenue*, 934 F.2d 1064, 1072 (9th Cir. 1991) (district court's "rubber stamp" of master's order was "inexcusable abdication of judicial responsibility").

Similarly, when a district court assigns a case to a magistrate judge pursuant to 28 U.S.C. § 636(b), the district court must follow a notice and objection procedure virtually identical to that applicable to special masters' reports. However, the district court judge is expressly required to make a *de novo* determination of any matters to which objections are raised. "The merit of the *de novo* determination scheme lies in the duty of the district court to make its own determinations of magistrate rulings to which the parties object...." *Pacemaker Diagnostic Clinic of America v. Instromedix*, 725 F.2d 537, 546 (9th Cir.), *cert. denied*, 469 U.S. 824 (1984). The purpose of these procedures in the case of magistrates and masters is to ensure that these officers are not allowed to make the decision of the district court, in violation of Article III of the Constitution. S. Rep. No. 371, 90th Cong., 1st Sess. 12.

In contrast to the notice and objection procedures of the Federal Rules applicable to district court review of reports of magistrates and masters, under Tax Court Rule 183(b) parties are not entitled to receive prior notice of or an opportunity to file objections to the special trial judge's report before the Tax Court judge acts on it. This was not the case before 1984 when Congress enacted I.R.C. § 7443A(b)(4) to permit special trial judges to hear any proceeding assigned by the chief judge. Before 1984, the Tax Court's review procedures under the predecessor of Tax Court Rule 183 had virtually the same notice and objection procedures as the district court rules. It is doubtful that Congress would have sanctioned the use of special trial judges by statute if it had been informed that judges would review reports of special trial judges without giving the parties the right to make objections before they were acted on by the judges. *Freytag, supra*, at 875 ("The 1984 amendment was 'technical' in light of the historical development of the special trial judge's role ...").

With no other avenue to pursue under the Tax Court's rules, Erhard filed a motion for reconsideration pursuant to Tax Court Rule 161. This, however, was no substitute for the opportunity to object to the report before the judge acted on it because the granting of a motion for reconsideration pursuant to Tax Court Rule 161 rests within the discretion of the Court. *Estate of Halas v. Commissioner*, 94 T.C. 570, 574 (1990); *Vaughn v. Commissioner*, 87 T.C. 164, 166-67 (1986). A motion for reconsideration will not be granted unless unusual circumstances or substantial error is shown. This standard is too stringent to substitute for the review of special trial judges' reports required by I.R.C. § 7443A.

The lack of any opportunity to file objections to the special trial judge's findings before the Tax Court judge ruled, therefore, created in this case exactly the same danger that

exists in the district court when cases are assigned to a magistrate or special master for trial — that is, "a danger that the district court [or Tax Court] will merely endorse the . . . report as its own decision." Linda J. Silberman, *Masters and Magistrates Part II: The American Analogue*, 50 N.Y.U. L. Rev. 1297, 1344 n.268 (1975). Because the statute prohibits perfunctory review or rubber-stamping of special trial judges' reports by the Tax Court, the Tax Court rules are inconsistent with I.R.C. § 7443A because they do not give taxpayers an opportunity to object to the report before its adoption by the Tax Court.

CONCLUSION

The petition for a writ of *certiorari* should be granted.

July 24, 1995

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APPENDIX A

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U.S. COURT OF APPEALS

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

Nos. 93-70357
Tax Ct. No. 39473-85

WERNER H. ERHARD,
Petitioner-Appellant,

v.

COMMISSIONER INTERNAL REVENUE SERVICE,
Respondent-Appellee.

Nos. 93-70359
Tax Ct. No. 46712-86

WERNER H. ERHARD,
Petitioner-Appellant,

v.

COMMISSIONER INTERNAL REVENUE SERVICE,
Respondent-Appellee.

Nos. 93-70360
Tax Ct. No. 49532-87

ORDER

WERNER H. ERHARD,
Petitioner-Appellant,

v.

COMMISSIONER INTERNAL REVENUE SERVICE,
Respondent-Appellee.

Before: LAY,* PREGERSON, and O'SCANNLAIN, Circuit Judges.

The panel has voted to deny the petition for rehearing. Judges Pregerson and O'Scannlain have voted to reject the suggestion for rehearing en banc, and Judge Lay has so recommended.

The full court has been advised of the en banc suggestion, and no judge of the court has requested a vote on it.

The petition for rehearing is DENIED and the suggestion for rehearing en banc is REJECTED.

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*The Honorable Donald P. Lay, Senior United States Circuit Judge for the Eighth Circuit, sitting by designation.

APPENDIX B

FOR PUBLICATION

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

Nos. 93-70357
Tax Ct. No. 39473-85

WERNER H. ERHARD,
Petitioner-Appellant,
v.
COMMISSIONER INTERNAL REVENUE SERVICE,
Respondent-Appellee.

Nos. 93-70359
Tax Ct. No. 46712-86

WERNER H. ERHARD,
Petitioner-Appellant,
v.
COMMISSIONER INTERNAL REVENUE SERVICE,
Respondent-Appellee.

Nos. 93-70360
Tax Ct. No. 39532-87

OPINION

WERNER H. ERHARD,
Petitioner-Appellant,
v.
COMMISSIONER INTERNAL REVENUE SERVICE,
Respondent-Appellee.

Appeal from a Decision of the United States Tax Court

Argued and Submitted November 17, 1994 — San Francisco, California

Filed February 8, 1995

Before Donald P. Lay,* Harry Pregerson, and Diarmuid F. O'Scannlain, Circuit Judges.

Opinion by Judge O'Scannlain

SUMMARY

Tax/Income/Interest

The court of appeals affirmed a decision of the United States Tax Court. The court held that the tax court, in deciding whether a taxpayer was entitled to interest deductions, committed no clear error in finding that the taxpayer's circular borrowing transactions lacked economic substance.

Appellant Werner Erhard hired tax attorney Harry Margolis to be his personal financial and legal advisor. Margolis created a corporation, "est, a.e.c.," the stock of which was seemingly owned by a complex web of offshore entities created by Margolis. Erhard purported to be just an employee of est, a.e.c., without any legal ownership interest. Integral to est, a.e.c. was the Margolis "system." The system was composed of offshore and domestic corporations, trusts, banks, partnerships and other entities that were used to implement Margolis'

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*The Honorable Donald P. Lay, Senior United States Circuit Judge for the Eighth Circuit, sitting by designation.

tax planning. Such "system entities" were controlled by Margolis. The est, a.e.c. organizational structure was a maze of intertwined organizations with numerous agreements among the entities involved. Margolis created a variety of system entities which dealt only with est, a.e.c.. The purpose of this organization was to "try to get money paid offshore in a deductible fashion," and have it "find its way onshore in a non-income fashion." In a typical circular money movement, funds would pass from one system entity to a taxpayer, and then from the taxpayer to a second system entity for some ostensible business purpose of the taxpayer. Thus, the taxpayer would appear to have incurred a substantial expenditure, whereas he in reality had merely taken money from, and then returned it to, the system. Transactions between system entities were not recorded. Margolis maintained only one combined "system accounting" for Erhard and est, a.e.c.

After Margolis was acquitted of criminal tax charges, Erhard set out to "create est anew." Werner Erhard and Associates (WEA) was established. WEA needed to acquire the assets of est, a.e.c. and needed funds for the acquisition.

The asset acquisition was accomplished in four phases. In phase one, Erhard borrowed money that originated with the system and then transferred back an amount to various system entities, retaining some of the money for operating expenses. In phase two, a system entity loaned WEA money. WEA retained some of the money and transferred the rest back into the system. In phase three, Margolis arranged for a nonsystem entity, the Intercultural Cooperation Foundation (ICF) to accept funds from a Margolis system entity and then lend those funds to WEA. Margolis also contacted the co-founder of another nonsystem entity, the St. John Fundacion, who likewise agreed to act as a conduit for the loan so long as the funds were made available to him. The ultimate source of the

$14 million loaned to Erhard during phase three was Island Bank, a system entity. Phase four was financed with a $1 million demand loan from ICF through St. John. System entities were the source of the funds. At the close of the four phases, WEA had acquired all of est, a.e.c.'s operating assets. The two remaining loans were owed to ICF.

WEA paid interest to ICF on the loans. WEA properly withheld ICF's federal income tax from its payments to ICF and transmitted these amounts to the Internal Revenue Service (IRS). WEA paid $1 million, purportedly in repayment of the $1 million demand loan.

On their returns for three tax years, Erhard and WEA claimed depreciation and interest deductions based on their transactions. The IRS disallowed all the deductions and asserted additions to tax, as well as increased interest. Erhard petitioned the tax court for a redetermination of the asserted deficiencies, and the cases were assigned to a special trial judge (STJ) for hearing. After a six-week trial, the cases were assigned to a tax court judge, who adopted the STJ's opinion, which held that Erhard was not entitled to interest or depreciation deductions because the transactions through which they were generated lacked economic substance. The opinion also sustained the determination and imposition of increased interest. After Erhard filed a motion for reconsideration, the tax court determined that he was entitled to some depreciation deductions.

Erhard appealed, challenging the disallowance of interest deductions, the imposition of increased interest and the tax court's computations of his deficiency. Erhard contended that the case should be remanded to the tax court because the tax court judge improperly allowed the STJ to make the decision of the tax court. Erhard also challenged the tax court's finding of sham.

[1] The chief judge of the tax court may assign a case to be heard by an STJ, but the STJ has no authority to decide the case. The STJ submits a report to the assigned tax court judge. [2] In this case, the record was so voluminous that it was perfectly reasonable for the tax court judge not to read every word. The tax court judge made it clear that while she did rely on the STJ's findings, she did not "take them carte blanche." [3] The tax court judge's review of the case was adequate. The few errors that the tax court judge made were understandable in light of the case's enormous complexity. Thus, there was no reason to remand.

[4] In order to be deductible, interest must be paid on genuine indebtedness, an indebtedness in substance and not merely in form. The burden is on the taxpayer to show that the borrowing scheme was a bona fide arrangement entered into for economic purposes, rather than merely a tax avoidance scheme. [5] In this case, the tax court committed no clear error in finding that the transactions at issue lacked economic substance. [6] During phases one and two, even though it appeared as though Erhard transferred millions of dollars to est, a.e.c. in exchange for assets, the system was the source not only for the purchase money but also for the additional $3 million that represented est, a.e.c.'s cash reserves. [7] Further, the convoluted, circular path of the two ICF loans in phases three and four simply made it hard to believe that the loans were bona fide. The funds began with the system, went through nonsystem entities in order to provide the transaction with legitimacy, and then went back to the system. Margolis was intimately involved in all the transfers. He arranged for the loans and helped prepare the agreements between the parties. Thus, the fact that Erhard made some subsequent payments to ICF did not lead to the conclusion that the tax court committed clear error in its finding of sham.

[8] Before its repeal, Internal Revenue Code§ 6621(e) imposed increased interest on an understatement of tax to the extent that the understatement was a "substantial underpayment attributable to tax motivated transactions." [9] This section, on its face, applied to *any* sham or fraudulent transaction.

[10] Erhard also contended that the tax court abused its discretion by refusing to accept his computations as to the useful lives of ther depreciable assets and by refusing to credit him for amounts that he withheld from his payments to ICF. [11] However, the tax court did not abuse its discretion in refusing to accept his calculations. The record did not disclose the useful life of each of the assets which remained at the time of the asset acquisition. [12] In addition, the amounts Erhard remitted to the IRS were withheld from payments to ICF and thus were in payment of ICF's tax, not Erhard's tax.

COUNSEL

Michael I. Saltzman, Baker & McKenzie, New York, New York, for the petitioner-appellant.

William J. Patton, Tax Division, United States Department of Justice, Washington, D.C., for the respondent-appellee.

OPINION

O'SCANNLAIN, Circuit Judge:

We are invited to follow the winding paths of circular money movements to determine whether they lead to transactions of economic substance for federal income tax purposes.

I.

Werner Erhard has offered a variety of seminars, workshops, and other programs in personal effectiveness since 1971. At that time, Erhard hired tax attorney Harry Margolis

to be his personal financial and legal advisor. Margolis arranged the formation and financing of Erhard Seminars Training, Inc.

In 1975, Margolis created a new corporation, " est, a.e.c.," to assume the activities of Erhard Seminars Training, Inc. The stock of est, a.e.c. was seemingly owned by a complex web of offshore entities created by Margolis.[1] Erhard purported to be just an employee of est, a.e.c., without any legal ownership interest.

Integral to both est, a.e.c. and its predecessor, Erhard Seminars Training, Inc., was the Harry Margolis "system." The system was composed of offshore and domestic corporations, trusts, banks, partnerships, and other entities that were used to implement Margolis' tax planning. Such so-called "system entities" were controlled either directly or indirectly by Margolis. The est, a.e.c. organizational structure devised by Margolis was a maze of intertwined organizations with numerous agreements among the entities involved. After Margolis created est, a.e.c., he created a variety of system entities which dealt only with est, a.e.c. As Erhard's counsel explained, the main purpose of such an organization was "to try to get money paid offshore in a deductible fashion, and then the money would find its way onshore in a non-income fashion," Reporter's Transcript, volume 22 at 102.

In implementing this tax planning, Margolis devised orchestrated money movements that were structured by contractual arrangements. In a typical circular money movement, funds would pass from one system entity to a taxpayer, and then from the taxpayer to a second system entity for some ostensible business purpose of the taxpayer. Thus, the taxpayer would appear to have incurred a substantial expenditure, whereas he in reality had merely taken money from,

[1]The ownership of est, a.e.c. was so complex that when Erhard decided to alter the organizational structure in 1981, it apparently took his legal and financial advisors months to sort through the complicated legal and financial structures that Margolis had used in his planning.

and then returned it to, the system. Consequently, Margolis' transactions have been described as "financial gymnastics, devoid of economic substance." *Goldberg v. United States*, 789 F.2d 1341, 1343-44 (9th Cir. 1986).

Margolis maintained so-called "system accounting" for his clients which consisted of a chronological list of the client's transactions within the system and which kept tract of the client's balance, either positive or negative, vis-a-vis the system. All funds that went into the system from a client or a nonsystem entity were entered as a credit to the client while all funds that went out of the system to a client or a nonsystem entity were entered as a debit to the client. A client earned interest on positive balances in the system accounting and was charged interest on negative balances. Transactions between system entities were not recorded because the funds stayed in the system. Though Erhard purportedly had no ownership interest in est, a.e.c., Margolis maintained only one combined system accounting for Erhard and est, a.e.c.

The tax court found that Margolis' representation of clients generally consisted of three phases. During the initial phase, the client's goals were defined and documents were drafted to realize the goals. Then, followed an implementation stage during which the required relationships were established. Finally, there was a clean-up phase when the client wished to terminate the contractural relationships. Where required, money movements would be made in order to complete the clean-up phase. *Erhard v. Commissioner*, 62 T.C.M. (CCH) 1, 3 (1991). In a memorandum of May 1980, Margolis stated that at the time est, a.e.c. was formed in 1975, it was contemplated that the corporation would not exist for more than three years. *Id.* at 4.

In 1976, Margolis was indicted on criminal tax charges. He was acquitted of all charges in 1977, but after the indictment, Erhard allegedly became concerned about negative publicity

surrounding Margolis' involvement in est, a.e.c. Further, the Margolis system was so complex that Erhard could not assess his own financial condition or that of est, a.e.c. Thus, in January 1980, Erhard announced the initiation of a project to "create est anew." To that end, Erhard formed a task force composed of est, a.e.c. executives, staff members, and outside legal advisors. In May 1980, Erhard issued a memorandum advising his staff that Erhard, Margolis, and the task force had jointly determined to replace Margolis as the general and tax counsel of est, a.e.c.

The task force recommended that Erhard convert the operation into a sole proprietorship. Accordingly, Werner Erhard and Associates ("WEA") was established as a sole proprietorship in February 1981. At this point, WEA needed to acquire the assets of est, a.e.c. WEA also needed funds for the acquisition. As for the funds, Margolis indicated that, "[t]he truth is that there is no source other than the accumulated values of the past decade." *Id.* at 12.

The asset acquisition was accomplished in four phases. In the first phase, which occurred in June and July 1981, Erhard borrowed $2,200,000 from Terla, B.V., a system entity and $5,000,000 from Barclays Bank of San Francisco. Barclays Bank was not a system entity, but the loan was a back-to-back loan secured by Parallax Corp., a system entity.[2] Thus, the money lent to WEA originated with the system. WEA immediately transferred $4,950,677 back to various system entities, alleged in payment for assets. However, out of the aggregate loan proceeds of $7,200,000, Erhard retained $2,249,323 for operating expenses.

[2]A back-to-back loan occurs when a bank loan is collateralized with a cash deposit from a third party. When the loan principal is repaid, then the compensating deposit is released. In the Margolis' system accounting, a system entity's deposit securing a back-to-back loan was treated as a charge against the client receiving the loan from the bank. The client's account was credited when the loan was repaid and the deposit released back to the system entity.

Phase two occurred on or about August 27, 1981 and was financed through three separate loans to WEA from Terla, a system entity, in the aggregate amount of $6,580,000. WEA retained $850,854 and transferred the rest back into the system through a number of system entities. Thus, in phases one and two, Erhard retained a total of approximately $3 million while the rest of the money cycled out of, and back into, the system.

Phase three took place on September 15, 1981. At this point, WEA owed approximately $13,800,00 in short-term debt to Terla and Barclays Bank. Erhard desired to replace his short-term debt with a long-term loan. Accordingly, Erhard called Wolfgang Somary, co-founder of Intercultural Cooperation Foundation ("ICF"), seeking to borrow money for WEA. ICF had no money to lend; however, shortly thereafter, Margolis called Somary and arranged for ICF to accept funds from a Margolis system entity and then to lend those funds to WEA. Margolis also contacted Fernando Flores, co-founder of the St. John Fundacion, who likewise agreed to act as a conduit for the loan so long as the funds were made available to him. As nonsystem entities, ICF and St. John were enlisted to participate because Erhard's outside lawyers regarded a fully disclosable source of the loan as essential to an acceptable asset acquisition plan.

The ultimate source of the $14 million eventually loaned to Erhard during phase three was Island Bank, a system entity. On September 15, 1981, Island Bank transferred $96 million to Sineuri, S.A., another system entity. From this amount, Sineuri transferred $15 million to Brown Education Corp., ("BEC"). BEC had been formed just prior to this transaction as part of Margolis' tax planning. BEC then purported to loan $14 million to ICF. BEC transferred the money to an account in the name of Everd van Walsum, a Margolis associate

who was acting on behalf of ICF.[3] BEC was ostensibly loaning this money to ICF, yet ICF never provided BEC financial statements. The agreement that ICF and BEC did execute had been drafted with significant help from Margolis. Moreover, ICF agreed to receive funds from BEC only on condition that ICF would not be liable to BEC if WEA defaulted on the loan.

ICF then loaned the $14 million to St. John Fundacion, transferring the money to Paul Mason, a Margolis associate who was acting on behalf of St. John. Margolis also had a hand in drafting the documents executed between ICF and St. John. St. John then made a loan of $14 million to Erhard and WEA. St. John did nothing to ensure that the loan would be repaid by Erhard. Indeed, Flores immediately endorsed the instrument to ICF. BEC also assigned to Island Bank all right, title, and interest in the promissory note from ICF.

On the same day that Erhard received the money (which was the same day that all the above transactions occurred), Erhard transferred it all back to Island Bank, a system entity. Island Bank then transferred $8,976,284.95 to Terla B.V. as payment for the loans Erhard obtained during phases one and two. Island Bank also transferred $5,023,500 to Barclays Bank in payment for the loan Erhard obtained during phase one. Payment of the Barclays loan released the collateral deposit back to Parallax, the system entity that had secured the loan.

Phase four took place in December 1981, ostensibly because Erhard needed more money to complete the asset acquisition. This phase was financed with a $1 million demand loan again from ICF through St. John. The source of the funds was Antigua Banking, Ltd., and ABC Trust Company, both system entities. Over a four-month period, Antigua and ABC funneled

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[3]BEC also transferred $1 million back to Island Bank.

the funds to the Harry E. Wright, Jr. Charitable Trust, a Margolis client. On August 27, 1981, the Trust transferred $750,000 to Island Bank. On December 17, 1981, the Trust transferred $250,000 to Island Bank. On December 18, 1981, Island Bank transferred $1 million to ICF. ICF then transferred $1 million to St. John, which on the same day transferred the funds to WEA. WEA then transferred the $1 million, plus an additional $547,645 to est, a.e.c.

Thus, at the close of the four phases, WEA had acquired all of est, a.e.c.'s operating assets.[4] It had replaced its short-term loans and owed a total of $15 million, consisting of a $1 million demand loan and a $14 million long-term loan. Both loans were owed to ICF.

WEA paid interest to ICF on both the demand loan and the long-term loan. WEA properly withheld ICF's federal income tax from its payments to ICF and transmitted these amounts to the IRS. In early 1985, WEA paid $1 million, purportedly in repayment of the $1 million demand loan. However, Erhard transferred $550,000 directly to Island Bank rather than to ICF. Island Bank informed ICF that it would not release the $550,000 unless ICF initiated legal action in California to uphold the validity of the $14 millon note in Erhard's then-active matrimonial action. Thus, of the $450,000 ICF did receive, it spent approximately $400,000 to defend the $14 million note.

On their returns for the tax years of 1981, 1982 and 1983, Erhard and WEA claimed depreciation and interest deductions based on the transactions described above. The IRS disallowed all the deductions and asserted additions to tax under sections 6653(a)(1), 6653(a)(2), and 6661, as well as increased interest under section 6621(c). Erhard petitioned the tax court for a redetermination of the asserted deficiencies, and the cases

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[4]WEA had also acquired some artwork, an auxiliary sloop, and various recreational vehicles.

were assigned to Special Trial Judge Gussis for hearing. Erhard objected to the assignment on the ground that Judge Gussis was biased against Erhard because he presided over two prior cases involving est, a.e.c. The tax court denied Erhard's motion, and this court denied his petition for mandamus. After a six-week trial, the cases were assigned to Tax Court Judge Scott, who adopted Judge Gussis' opinion. The opinion held that Erhard was not entitled to interest or depreciation deductions because the transactions through which they were generated lacked economic substance, and it sustained the determination and imposition of increased interest under section 6621(c).

On September 3, 1991, Erhard filed a motion for reconsideration. The tax court reaffirmed its conclusions with regard to the disallowance of interest deductions and the determination and imposition of increased interest. The court determined, however, that Erhard was entitled to some depreciation deductions. The court then stated that "decisions will be entered under Rule 155." *Erhard v. Commissioner*, 64 T.C.M. (CCH) 10, 15 (1992). Erhard and the Commissioner disagreed about the appropriate computations under Tax Rule 155 and this appeal followed.

Erhard raises three issues on appeal: (1) the disallowance of interest deductions; (2) the imposition of increased interest; and (3) the tax court's computations of Erhard's deficiency.

II

Erhard first argues that this court should remand the case to the tax court, asserting that Judge Scott improperly allowed the special trial judge to make the decision of the tax court.

[1] The chief judge of the tax court may assign a case to be heard by a special trial judge, IRC § 7443A(b)(4); however, the special trial judge has no authority to decide the case. IRC

§ 7443A(c). Rather, the special trial judge submits a report to the assigned tax court judge, who must "review the work of the special trial judge." *Freytag v. Commissioner*, 111 S. Ct. 2631, 2635 n.2 (1991). The litigants do not automatically receive a copy of the report and, therefore, are not routinely allowed to file objections to it.

Once the tax court judge has reviewed the report, she

> may adopt the Special Trial Judge's report, or may modify it or may reject it in whole or in part, or may direct the filing of additional briefs or may receive further evidence or may direct oral argument, or may recommit the report with instructions.

Tax Court Rule 183(c). Whichever course the tax court judge takes, she must presume that the special trial judge's findings of fact are correct, and she must give "[d]ue regard" to the fact "that the Special Trial Judge had the opportunity to evaluate the credibility of witnesses." *Id.* Here, Judge Scott adopted Special Trial Judge Gussis' report. Erhard was not permitted to file objections to the report prior to Judge Scott's action.

Erhard first argues that because the parties are not provided an opportunity to object to the special trial judge's report, it is likely that the special trial judge will end up deciding the case.[5] Indeed, permitting the litigants to file objections to the special judge's report might well decrease the danger that the tax court judge will simply endorse the report without review, *see* Linda J. Silberman, *Masters and Magistrates Part II: The American Analogue*, 50 N.Y.U. L. Rev. 1297, 1344

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[5]Erhard analogizes special trial judges in the tax court to special masters and magistrates in the district court, pointing out that litigants in the district court are permitted to file objections to the special master's report before the district judge acts on it.

n.268 (1975). Yet, absent such a procedure, the tax court judge will not necessarily abdicate her judicial responsibility. The Supreme Court has cautioned specifically that " 'rubber stamp' activity" on the part of the tax court judge is not to be assumed. *Freytag*, 111 S. Ct. at 2653 n.2.

[2] Second, Erhard maintains that Judge Scott, in fact, did not adequately review the case. Erhard makes much of several quotes from Judge Scott where she admits that she relied on Special Judge Gussis' findings and did not examine every exhibit nor read the entire transcript. However, these admissions do not lead to the conclusion that Judge Scott's review was inadequate. First of all, Tax Court Rule 183 requires Judge Scott to give "due regard" to Judge Gussis' report on findings of fact and credibility. Further, the record in this case is so voluminous[6] that it was perfectly reasonable for Judge Scott not to read every word. Judge Scott made clear that while she did rely on Judge Gussis' findings, she did not "take them carte blanche."

Finally, Erhard maintains that Judge Scott's comments during the reconsideration hearing showed that she misunderstood important facts. Erhard points out that Judge Scott mistakenly believed that ICF and the Harry E. Wright, Jr. Charitable Trust were system entities, and that Erhard owned stock in est, a.e.c. Erhard contends that these mistakes show that Judge Scott did not adequately review the record.

[3] After carefully examining the record and Judge Scott's comments, we are convinced that Judge Scott's review of the case was adequate. Erhard points to isolated mistakes; however, Judge Scott's other comments indicate a satisfactory understanding of the case. Further, we believe that the few errors Judge Scott did make were understandable in light

[6]The transcript comprised 27 volumes.

of the case's enormous complexity. Although the Wright Trust was not a system entity, it was a Margolis client, and the Commissioner has claimed that it was effectively controlled by Margolis. Similarly, ICF, though not a system entity, clearly took part in the transactions at Margolis' request and with his direction. Finally, Judge Scott's confusion about Erhard's ownership of est, a.e.c. also is understandable given that everyone seemed to acknowledge that Erhard was the "owner" of the business, and given est, a.e.c.'s purposefully complicated organization structure. Accordingly, we see no reason to remand.

III

Erhard next challenges the tax court's finding of sham. The tax court's determination that a transaction is lacking in economic substance is a factual determination that this court reviews for clear error. *Karme v. Commissioner*, 673 F.2d 1062, 1065 (9th Cir. 1980)[7]

[4] At issue here are interest deductions that Erhard claimed for the ICF loans and the Terla B.V. loans. Section 163(a) of the Internal Revenue Code provides for an income tax deduction for "interest paid or accrued within the taxable year on indebtedness." In order to be deductible, however, interest must be paid on genuine indebtedness, an indebtedness in substance and not merely in form. *Knetsch v. United States*, 364 U.S. 361 (1960). The burden is on the taxpayer to show that the borrowing scheme was a bona fide arrangement entered into for economic purposes, rather than merely a tax avoidance scheme. *Valley Title Co. v. Commissioner*, 559 F.2d 1139, 1141 (9th Cir. 1977).

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[7]Contrary to Erhard's contention, *Casebeer v. Commissioner*, 909 F.2d 1360, 1362 (9th Cir. 1990) does not set forth a de novo standard for review of sham transactions.

The tax court found that the transactions at issue here were without economic substance; that they were merely circular money movements that "began and ended with system entities, with no change in the economic position of the system viewed as a whole." 62 T.C.M. (CCH) 1, 26 (1991).

After conducting a detailed examination of each of the phases, the court concluded the following: In phases one and two, most of the borrowed money simply circled out of the system, through WEA, and back into the system. However, WEA retained approximately $3 million purportedly to use for operating expenses. In phase three, the entire $14 million loan circled through the system in one day. *Id.* After recounting the convoluted series of transactions involved in phase three, the court concluded that the "loans which had originated from system funds (directly or indirectly) in phases one and two were repaid with system funds in phase three, and the total amount of such repayments were returned, directly or indirectly, to the system." *Id.*

The court found that the $1 million loan in phase four followed a similar pattern. "Again, the funds originated in a money movement from the Margolis system through the Harry E. Wright, Jr., Charitable Trust, to Island Bank, Ltd., to Intercultural Cooperation Foundation to St. John Fundacion to WEA and from WEA to est, a.e.c." *Id.* Consequently, the tax court concluded that "the $14,000,000 and $1,000,000 loans purportedly obtained by petitioner to finance the acquisitions were sham transactions completely lacking in economic substance." *Id.* at 27.

The court's findings of sham are based on its conclusion that the complex est, a.e.c. organizational structure was simply a means of shielding "the true ownership of assets that in reality belonged to the Werner Erhard operation." *Id.* at 28. The court concluded that the entire series of transactions "merely

represented the so-called 'clean-up' phase in which the structure created by Margolis for Werner Erhard in 1975 was shed as a prelude to a new structure." *Id.* at 27. The court, noting that no "effort was made in the system accounting to differentiate between Werner Erhard and the entities (Erhard Seminars Training, Inc., and est, a.e.c.) which were used to conduct the Erhard business over the years," found that the system accounting simply served to reflect a client's cash position within the system. *Id.* Thus, when est, a.e.c. was to be dismantled in favor of a new structure, Erhard needed to balance accounts with the system and to remove the assets which, in reality were his, but which had been acquired in the name of various system entities.

> This was accomplished in the transactions which took place for the most part in phases one through four in 1981. Werner Erhard or (WEA) obtained all the business assets needed to continue his operations. Personal loans owed by Werner Erhard in substantial amounts were paid. He also acquired possession of art work valued at some $765,038 which had been held in the name of a system entity, the auxiliary sloop Sirona valued at $225,000 which had also been held in the name of a system entity and certain motor vehicles. It also appears that some $3,000,000 remained with Erhard (or WEA) as a result of the circular money movements in phases one and two.

Id.

Thus, the court concluded: "We believe that est, a.e.c. was in effect terminated as originally contemplated in 1975, a financial accounting was rendered for Werner Erhard covering some 10 years of close invovlement with the system and its entities, and the assets transferred to Werner Erhard in an artifical series of transactions that produced . . . interest expense deductions." *Id.* at 28.

[5] Although Erhard valiantly attempts to discredit these findings, we are more than satisfied that the tax court committed no clear error in finding that the transactions lacked economic substance.

Erhard first points out that est, a.e.c. was a multi-million dollar business before the asset purchase, as was WEA after the purchase. This, however, is beside the point. The tax court found the asset acquisition to be a sham, not because est, a.e.c. itself was a sham, but because Erhard never really bought est, a.e.c.

Second, Erhard maintains that the court's conclusions about circular money movements are contradicted by the court's own finding that WEA retained a portion of the borrowed funds. However, the court was fully aware that not all the money circulated. Indeed, the court found that the funds that Erhard retained constituted est, a.e.c.'s excess cash balances that needed to be transferred to Erhard in order to square the accounts. This conclusion is supported by the evidence. In a May 20, 1981 memorandum, Margolis indicated that when all the contemplated transactions were concluded, the cash position of est, a.e.c. would be reduced by $2,950,000 while the cash holdings of WEA would increase by that amount.[8]

Third, Erhard maintains that he had a clear business purpose for engaging in the transactions because he desired to

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[8]Erhard also argues that the tax court erred as a matter of law by admitting inaccurate IRS charts as evidence of circular money movements. Erhard's claim is meritless, however. Erhard is correct that the charts do not include certain transactions, but it is clear from the court's opinion that the court was aware of and considered these transactions in making its determination.

terminate his relationship with Margolis.[9] However, even if Erhard had a legitimate business purpose for terminating his relationship with Margolis, that did not give him a business purpose for engaging in the specific transactions at issue here. The fact that he may have had a good business reason for separating from Margolis does not necessarily justify resorting to circular money movements (that just happened to create tax benefits) to effectuate that separation.

Finally, Erhard points out that even though the $14 million loan in phase three and the $1 million loan in phase four came from system entities and were immediately returned to system entities, Erhard nonetheless paid over $2 million in interest on the loans over the next several years. He also repaid the $1 million demand loan in 1985. These payments, according to Erhard, are evidence that he was genuinely indebted; after all, he would not have made any payments if the loans had been shams.

[6] We agree that such payments would ordinarily indicate genuine indebtedness; however, the facts of this case immediately dispel such a suggestion. The evidence shows the following: Margolis created the amazingly complicated est, a.e.c. organizational structure, with its numerous offshore entities, in order that money could be "paid offshore in a deductible fashion, and then the money would find its way onshore in a non-income fashion." Reporter's Transcript, volume 22 at 102. Though nominally just an employee of est, a.e.c.,

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[9]Erhard also claims that the court applied the wrong test for business purpose. Erhard claims that because the court rejected his asserted business purpose argument on the ground that it was not "convincing" the court erroneously applied an objective test rather than a subjective test. 62 T.C.M. (CCH) 1, 28 (1991). However, Erhard seems to be arguing that unless the court blindly accepts Erhard's assertions, then it is applying an objective test. The text of the opinion shows that the court was not substituting its opinion for Erhard's. Rather, the court was merely stating that, based on the evidence, it did not believe Erhard's assertions.

Erhard was understood to be its owner. So, when Erhard decided to transform est, a.e.c. into a sole proprietorship, the assets that were ostensibly the property of est, a.e.c. were transferred to Erhard in exchange for payments that were really just circular money movements. Thus, during phases one and two, even though it appeared as though Erhard transferred millions of dollars to est, a.e.c. in exchange for assets, the system was the source not only for the purchase money but also for the additional $3 million that represented est, a.e.c.'s cash reserves.

[7] Further, the convoluted, circular path of the two ICF loans in phases three and four simply makes it hard to believe that these loans were bona fide. The funds began with the system, went through two nonsystem entities in order to provide the transaction with legitimacy, and then went back to the system. Margolis was intimately involved in all these transfers. He arranged for the loans between BEC, ICF, and St. John, and he helped prepare the agreements between the parties. None of these parties knew each other before the transactions, nor did they conduct any of the investigations that are customary in an arms-length transaction. Given this evidence, the fact that Erhard made some subsequent payments to ICF does not lead to the conclusion that the tax court committed clear error in its finding of sham. Indeed, these payments to ICF can be explained in any number of ways[10] that are wholly in keeping with the tax court's conclusion that the transactions lacked economic substance.

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[10]For example, the payments could very well have been rendered as a part of the final accounting between Erhard and the system. That is, the transactions that occurred during the four phases may have been calculated to take account of Erhard's subsequent payments to ICF.

IV

Erhard next contends that the tax court erred in imposing increased interest. This court reviews the tax court's imposition of increased interest pursuant to section 6621 for clear error. *Wolf v. Commissioner*, 4 F.3d 709, 715 (9th Cir. 1993).

[8] Before its repeal, IRC section 6621(c) imposed increased interest on an understatement of tax to the extent that the understatement was a "substantial underpayment attributable to tax motivated transactions." Prior to 1986, the section defined "tax motivated transactions" as including only four specific types of transactions.[11] The Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2750, amended section 6621(c) to add "any sham or fraudulent transaction" to the list of tax motivated transactions. The Commissioner imposed increased interest on Erhard on the basis of this last category.

[9] Erhard maintains that the legislative history indicates that a transaction does not come within the "sham or fraudulent transaction" category unless the transaction is a fraudulent version of one of the specific types of transactions that were originally defined to be tax motivated transactions.[12] However, Erhard's argument is not supported by language of the section or by precedent. *See Hildebrand v. Commissioner*, 967 F.2d 350, 353 (9th Cir. 1992). *See also Estate of Carberry*, 933 F.2d 1124, 1129-30 (2d Cir. 1991). The section, on its face, applies to *any* sham or fraudulent transaction. Thus, we reject the limitation Erhard urges as not plausible in light of the statute's clear language.

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[11]They were (1) any valuation overstatement; (2) any loss disallowed under the at-risk investment credit provisions; (3) any straddle transaction; or (4) any use of an accounting method that created distortion.

[12]Erhard argues that Congress added the "sham" category in order to reverse a line of tax court cases that refused to impose increased interest to a fraudulent straddle because fraudulent straddles are not really straddles.

V

[10] Finally, Erhard challenges the tax court's computations under Tax Court Rule 155. Computations under Rule 155 are reviewed for an abuse of discretion. *Kelly v. Commissioner*, 877 F.2d 756, 760 (9th Cir. 1989). Erhard alleges that the tax court abused its discretion (1) by refusing to accept his computations as to the useful lives of the depreciable assets, and (2) by refusing to credit him for amounts that he withheld from his payments to ICF.

A

Upon reconsideration, the tax court held that Erhard was entitled to depreciation deductions for certain assets that WEA acquired from est, a.e.c. The court directed that decisions would be entered under Tax Court Rule 155. The parties could not agree on the useful lines of those assets; therefore, each party submitted its own computation under Rule 155.

The Commissioner computed the useful lives of the assets by using the class life guidelines contained in the tables in Rev. Proc. 77-10, 1977-1 C.B. 548. Under this method, the Commissioner allowed Erhard to depreciate the assets from the date that est, a.e.c. transferred the assets to WEA. Erhard maintains, by contrast, that the useful lives of the assets should be computed from the earlier date the assets were acquired by est, a.e.c. in the amount identified from the est, a.e.c. tax returns that had been admitted into evidence.

A computation under Rule 155 must be made solely from the evidence in the record and the opinion of the tax court; it cannot be used to reopen the evidence or raise a new issue. Tax Court Rule 155(c). *See also Paccar, Inc. v. Commissioner*, 849 F.2d 393, 399-400 (9th Cir. 1988). Here, the tax court found that Erhard's computation was an accounting opinion

that raised a new issue of fact. Erhard disagrees, contending that, because the record already included est, a.e.c. tax returns, the remaining useful lives could be calculated "by simple mathematical computations from those returns."

[11] The tax court did not abuse its discretion in refusing to accept Erhard's calculations. The record does not disclose the useful life of each of the assets which remained at the time of the asset acquisition. Rather, Erhard's computations are based on information from est, a.e.c. tax returns. Though the returns are in the record, they were not stipulated to for accuracy or truth, and the Commissioner had no opportunity to contest the accuracy of particular items on the returns. Thus, we agree with the district court that determining the accuracy of Erhard's computations would require reopening the record to permit opinion testimony from both Erhard's accountant and the Commissioner's expert.

B

WEA withheld amounts from its purported interest payments to ICF and properly remitted the withheld amounts to the IRS on ICF's behalf. Erhard now claims that since the Commissioner has determined that he never really had an obligation to pay interest to ICF, then he was not a bona fide withholding agent and thus must have made the payments to the IRS for his own account.

[12] We are not persuaded by Erhard's argument. The amounts Erhard remitted to the IRS were withheld from payments to ICF and thus were in payment of ICF's tax, not Erhard's tax. Section 1464 provides that a refund or credit of an overpayment of tax which has actually been withheld at the source shall be made to the taxpayer from whose income the amount of such tax was in fact withheld. I.R.C. §1464; Treas. Reg. §1.1464-1(a); *Bank of America v. Anglin*,

138 F.2d 7, 8 (9th Cir. 1943). Thus, the IRS may refund any overpaid amount only to ICF, the taxpayer from whose income the tax was withheld. That the IRS deemed the loans shams does not transform payments made on behalf of ICF into payments made on behalf of Erhard. Erhard withheld that money on ICF's behalf regardless of the underlying purpose of the payments.

AFFIRMED.

APPENDIX C
UNITED STATES TAX COURT
WASHINGTON, D.C. 20217

Docket No. 39473-85

WERNER H. ERHARD AND
ELLEN V. ERHARD,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the opinion of this Court filed July 1, 1991, and the Supplemental Opinion filed July 6, 1992, petitioners on October 13, 1992, filed their computations for entry of decision under Rule 155 and on November 6, 1992, respondent filed a reply thereto, and on November 6, 1992, respondent filed her computations for entry of decision under Rule 155 and on December 11, 1992, petitioners filed objections thereto.

After consideration of the computations and the objections thereto, the Court on January 21, 1993, filed a Second Supplemental Memorandum Opinion in which it discussed and gave the reasons for its decision as to the differences in the computations filed by the parties and set forth its conclusion with respect to a proper computation. The premises considered, pursuant to the Memorandum Findings of Fact and Opinion filed July 1, 1991, the Supplemental Memorandum Opinion filed July 6, 1992, and the Second Supplemental Memorandum Opinion filed January 21, 1993, and incorporating herein as the find-

ings of the Court those findings as set forth in respondent's computations filed November 6, 1992, which were adopted by the Court in its Second Supplemental Memorandum Opinion filed January 21, 1993, it is

ORDERED AND DECIDED that there is a deficiency in income tax due from the petitioners for the taxable year 1981 in the amount of $396,920.00, without taking into consideration the jeopardy assessment made on April 8, 1991, against Werner H. Erhard and without taking into consideration payments made by petitioners after the mailing of the notice of deficiency, which amount is an overpayment by petitioners if the $396,920.00 deficiency is considered paid.

That there is no addition to tax due from petitioners for the taxable year 1981 pursuant to the provisions of I.R.C. section 6653(a).

That there is no addition to tax due from petitioners for the taxable year 1981 prusuant to the provisions of I.R.C. section 6661.

That the entire deficiency for the taxable year 1981 is a substantial underpayment for the purposes of computing the interest payable with respect to such amount pursuant to I.R.C. section 6621(c).

/s/ Irene F. Scott

Irene F. Scott
Judge

Entered: FEB 2 1993

APPENDIX D

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T.C. Memo. 1993-25

UNITED STATES TAX COURT

WERNER H. ERHARD AND ELLEN V. ERHARD, Petitioners, *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 39473-85, 46712-86, 39532-87, 137-88, Filed January 21, 1993.

Michael I. Saltzman, Barbara T. Kaplan, and *Robert F. Hermann,* for petitioners.

Carmen Baerga, Craig Connell, Mildred Moon, and *Raymond Kahn,* for respondent.

SECOND SUPPLEMENTAL MEMORANDUM OPINION

SCOTT, *Judge*: The Memorandum Findings of Fact and Opinion in these cases, T.C. Memo. 1991-290, was filed July 1, 1991. Petitioners timely filed a motion for reconsideration and a hearing on this motion was held on October 30, 1991. The Court granted the motion for reconsideration with respect to the allegation therein that the Court erred in holding that petitioners had not established a basis for depreciation for the years 1981, 1982, and 1983 for assets transferred to them in 1981 and in holding that petitioners were liable for the addition to tax under section 6661. All section references are to the Internal Revenue Code in effect for the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, unless otherwise indicated.

In a Supplemental Memorandum Opinion, T.C. Memo. 1992-376, filed July 6, 1992, we concluded that the record was

sufficient to establish the basis in the hands of petitioners for certain assets which petitioners took over from an entity, est, a.e.c., and, therefore, it was necessary to discuss among other things "what the useful life of these assets was at the time they were transferred to WEA". We stated that it appeared that the record was sufficient to determine the useful life of certain of the items which had been shown on the return of est, a.e.c., for its fiscal year ended June 30, 1981. Based on the Supplemental Memorandum Opinion filed July 6, 1992, we granted in part and denied in part petitioners' motion for reconsideration and stated that decisions would be entered under Rule 155.

Petitioners filed their computations for entry of decision allegedly in accordance with the Memorandum Findings of Fact and Opinion of the Court filed July 1, 1991, and the Supplemental Memorandum Opinion filed July 6, 1992, on October 13, 1992. On November 20, 1992, respondent filed objections to petitioners' computations. On November 6, 1992, respondent filed her computations for entry of decision, and on December 11, 1992, petitioners filed objections thereto.

The differences in the computations filed by the parties relate to: (1) The useful life which should be applied to the basis of the assets to compute depreciation on a straight line basis; (2) whether an amount which petitioners paid over to the Internal Revenue Service as a withholding tax on interest due to Intercultural Cooperation Foundation (ICF), an organization established under the laws of Switzerland, should be considered as a payment of tax made by petitioners, and, if so, how it should be reflected in the computations under Rule 155 and decisions of the Court; and (3) how some payments made by petitioners after the mailing of the notices of deficiency should be reflected in the computations under Rule 155 and decisions of the Court. Also, there are minor differences in

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the amounts shown by the parties as payments made by petitioners after the mailing of the notices of deficiency.

Respondent computed the useful life of office equipment and furniture, vehicles, and computers, the items with respect to which there is disagreement between the parties with respect to the useful life to be used, by using the class life tables contained in Rev. Proc. 77-10, 1977-1 C.B. 548. Respondent used the lower range of the useful life of each class of asset as set forth in Rev. Proc. 77-10, 1977-1 C.B. 548. Petitioners were unable to point to any specific evidence in the record setting forth the remaining useful life of any of the assets. Since petitioners contended that the depreciation should be on the remaining useful life of the assets considering the date the assets were acquired by est, a.e.c. rather than the date of the transfer of the assets to petitioners, petitioners employed an accountant to make a computation from various figures on the returns of est, a.e.c., to arrive at a computed remaining useful life of the assets. Petitioners referred to their method as one which could "constructively determine the original asset lives used by est, a.e.c. and the years remaining based on the depreciation amounts reported and the date at which the assets were placed into service by est, a.e.c.".

Petitioners attached to their objection to respondent's computations under Rule 155 an affidavit of a partner in the accounting firm of Ernst & Young explaining the method she used in computing "constructive useful lives" to arrive at her opinion of the constructively determined remaining useful lives.

It is well settled that a computation under Rule 155 must be made from the record and opinion of the Court and cannot be used to raise a new issue. *Estate of Stein v. Commissioner*, 40 T.C. 275, 280 (1963). Clearly, where it would be necessary to reopen the record to admit new evidence to decide a contention which a party attempts to raise under Rule 155, the is-

sue is a new issue which may not be raised in a Rule 155 computation. See *Cloes v. Commissioner*, 79 T.C. 933, 935 (1982).

Clearly here the record does not actually disclose the useful life of each of the assets involved which remained at the time petitioners received the assets from est, a.e.c. From the affidavit of the accountant and computations attached thereto we conclude that the computed remaining useful life of each asset is an accounting opinion of the accountant who did the computations and raises a new issue as to whether in fact these computations do properly result in the remaining useful life of each asset. To determine whether the useful lives as so computed are appropriate to use in computing depreciation for petitioners would require a reopening of the record to permit the accountant to give her opinion testimony and to afford respondent the opportunity to cross-examine with respect to her opinion, and, if appropriate, to offer the opinion of another accounting expert. This is not the province of a computation under Rule 155. We, therefore, sustain respondent's determination of the useful life of each of the classes of assets here involved.

The record is clear that the amount withheld from interest which petitioners claim was due to ICF was not a payment of petitioners' own tax, but rather a withholding of the tax of that foreign entity. Because we held that petitioners were not entitled to deduct the interest which they alleged was paid to ICF, petitioners contend that the withholding should be considered as tax paid by them. We do not agree with petitioners' logic. We held that the deduction petitioners claimed as an interest deduction was not properly allowable. However, whether or not peittioners made some payment to ICF from which a withholding was properly made was not an issue in these cases. Certainly the amount petitioners paid to the Internal Revenue Service as withholding from the payment to

ICF was in payment of a tax stated to be the tax of ICF and not petitioners' tax. This record shows that the amount which petitioners designated as "withholding tax" was in fact a payment of tax of ICF and not of petitioners. The withholding of a tax of ICF is not a payment of tax by petitioners.

It appears that petitioners did make some payments to the Government subsequent to the issuance of the notices of deficiency. However, there is nothing in the record in these cases to show the exact amounts of these payments, when they were made, and for what they were designated. The determination in this case is made as of the date of the issuance of the notices of deficiency unless the parties by stipulation agree otherwise. We will, therefore, determine in these cases the deficiency in each year without taking into consideration the jeopardy assessments made by respondent on April 8, 1991, against Werner H. Erhard and without taking into consideration payments made by petitioners after the date of the issuance of the notices of deficiency. The payments made after the issuance of the notices of deficiency can be handled by the parties in connection with collection of the deficiencies.

Decisions will be entered in accordance with respondent's computations as modified herein with respect to the payments made after the issuance of the notices of deficiency.

APPENDIX E

[CCH Dec. 48,325(M)]

Werner H. Erhard and Ellen V. Erhard v. Commissioner.

Docket Nos. 39473-85, 46712-86, 39532-87, 137-88. T.C. Memo. 1992-376, Filed July 6, 1992. [Appealable, barring stipulation to the contrary, to CA-9.—CCH.]

[Code Secs. 163, 167, 6621(c) (Prior to repeal by P.L. 101-239), 6653 (Prior to amendment by P.L. 101-239) and 6661 (Prior to repeal by P.L. 101-239)]

Depreciation: Deductions: Unrecovered basis: Depreciable assets: Additions to tax: Penalties: Negligence: Substantial understatement of tax: Reasonable reliance: Good faith. — Upon a motion for reconsideration (Dec. 47,434(M)), an individual was entitled to certain depreciation deductions for the unrecovered basis of assets transferred from a corporation to his sole proprietorship. The deductions were allowed for assets transferred to the extent that they could clearly be traced as going from the corporation to the sole proprietorship and used by the sole proprietorship in its business of conducting personal effectiveness seminars. Although many of the transactions between the corporation and the sole proprietorship were sham, the sole proprietorship was in substance one and the same as the corporation. In addition, the individual was not liable for additions to tax for substantial understatement of tax because there was sufficient evidence that he reasonably relied in good faith on the advice of lawyers and accountants in following a plan of taking over the assets of the corporation.—CCH.

Michael I. Saltzman, Barbara T. Kaplan, 805 Third Ave., New York, N.Y., and Robert F. Hermann, 820 Second Ave., New York, N.Y., for the petitioners. Carmen Baerga, Craig Connell, Mildred Moon, and Raymond Kahn, for the respondent.

Supplemental Memorandum Opinion

Scott, Judge: These cases are before us on petitioners' motion for reconsideration of the Memorandum Findings of Fact and Opinion filed in the above consolidated cases on July 1, 1991, T.C. Memo. 1991-290.

The motion for reconsideration alleged that the Court erred in concluding in its Memorandum Findings of Fact and Opinion (1) that petitioners were not entitled to interest expense deductions in 1981, 1982, and 1983 with respect to certain purported loans which the Court held not to be bona fide loans, but rather sham transactions, (2) that the Court erred in holding that petitioners had not established a basis for depreciation of assets transferred to them in 1981 for the years 1981, 1982, and 1983, and (3) in concluding that petitioners were liable for the addition to tax under section 6661[1] and increased interest under section 6621(c) in 1982 and 1983. A hearing was held on October 30, 1991, on petitioners' motion and thereafter the parties filed briefs.

Oral argument was held before Judge Scott with Special Trial Judge Gussis present in the courtroom. Judge Gussis joins in the conclusions in this opinion.

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[1]All section references are to the Internal Revenue Code in effect for the years in issue and all Rule references are to the Tax Court Rules of Practice and Procedure, unless otherwisde indicated.

Upon consideration of the arguments made by the parties orally and on brief, we conclude that for the reasons expressed in our Memorandum Findings of Fact and Opinion filed July 1, 1991, the purported loans of $14 million and $1 million discussed in that opinion were not in fact bona fide loans but were sham transactions, the result primarily of money movements. Therefore, based on the Memorandum Findings of Fact and Opinion filed on July1, 1991, we deny petitioners' motion for reconsideration with respect to our conclusion that interest deductions are not allowable with respect to the purported $14 million and $1 million loans since these purported loans were not bona fide indebtedness of petitioners. We also deny petitioners' motion for reconsideration of our holding that the purported purchases by petitioners of assets of est, An Educational Corporation (est, a.e.c.), with purported proceeds of such loans were sham transactions. We also deny petitioners' motion for reconsideration of our holding that petitioners are liable for increased interest under section 6621(c) because we reaffirm our conclusion that the transactions giving rise to the deficiencies in these cases were sham transactions and thus tax motivated within the meaning of section 6621(c)(3).

In our opinion we recognized and found that certain physical assets of a depreciable nature were transferred from est, a.e.c. to petitioners' sole proprietorship, Werner Erhard Associates (WEA), but held that the purported purchases were shams and the purported purchase price did not establish any basis of petitioners in the various assets. After reciting the facts with respect to the transfer of assets from est, a.e.c. to WEA, we concluded that in our view est, a.e.c. was in effect terminated as originally contemplated in 1975, that a financial accounting was rendered for Werner Erhard from the Margolis firm covering some 10 years of Erhard's involvement with the Margolis system and its entities, and that the est, a.e.c. assets

were transferred to WEA in an artificial series of transactions that were designed to produce depreciation expense deductions in 1981, 1982, and 1983 in the amounts of $884,024, $1,471,211, and $1,332,998, respectively. We stated that the circular money movements used with respect to the purported loans were shams designed merely to create tax deductions. On this basis we concluded that on the record before us petitioners were not entitled to the depreciation expense deductions claimed under section 167(a), stating: "In short, there is nothing in this record that would permit a finding of any basis for any of the assets in the hands of WEA."

Effectively we recognized that assets which had been in the stated possession of est, a.e.c. and on which depreciation had been claimed on the returns of est, a.e.c. had come into the hands of WEA. It is apparent from the nature of the assets that at least some of these assets were depreciable, and if the record were adequate to establish the basis, if any, of these assets in the hands of WEA and the remaining useful life of these assets at the time of transfer, WEA would be entitled to some depreciation deduction with respect to some of the assets transferred to WEA.

Our attempt to review the record to ascertain what basis, if any, the record supports for these assets in the hands of WEA has not been assisted by petitioners' continuous argument that the sham transactions purportedly purchasing these assets should be recognized and that the values assigned to the assets by petitioners in the returns for 1981, 1982 and 1983 be accepted. However, petitioners did call our attention to, and we find in the record, petitioners' Exhibit 177-6, a schedule of depreciation claimed by est, a.e.c. for its year ending June 30, 1981, which shows the following as it appears in Exhibit 177-6:

est, An Educational Corporation

Federal Corporation Statements — Year Ending 06/30/81

Depreciation As Computed Under Federal Statutes — Statement 7 — Amortization

Non-Recovery Property

Description	Date Acquired	Cost Or Other Basis	Accumulated Amortization	Method	Useful Life Yrs Pct	Current Amortization
License	09/01/75	10,000,000	4,833,332	SL	10	916,653
Graduate List	09/01/75	631,760	305,355	SL	10	57,925
Graduate List Sold	06/01/81	-531,470	-248,166	SL		0
Registration List Written Off	06/01/81	-118,290	-57,189	SL		0
Totals		10,000,000*	4,833,332*			974,578*
Total Depreciation						974,578**

We also find that the record contains as petitioners' Exhibit 659 the docket entries of respondent's motion to dismiss for failure to properly prosecute to which is attached a copy of the notice of deficiency and the order of dismissal in the case of est, An Educational Corporation, docket No. 3014-85. The deficiency notice with respect to the depreciation schedule for the fiscal year of est, a.e.c. ended June 30, 1981, which is the year involved in docket No. 3014-85, shows adjustments disallowing a claimed interest deduction, disallowing amortization of $974,578, and determining other income by disallowing a claimed Hopi partnership loss of $773,762, and "wardrobe" of $3,111. The only other adjustment in this notice was an increase in the claimed deduction for contributions of $3,628. The deficiency notice with respect to the disallowance of the amortization expense states:

> The amount of $974,587 claimed as amortization expense is disallowed because it has not been established that:
>
> (1) You are the equitable or beneficial owner of the property; and
>
> (2) The basis claimed for the property should be recognized as bona fide for tax purposes; and
>
> (3) The amount claimed represents a reasonable allowance for amortization expense.

Amortization of license granted by Welbehagen B.V.	$916,653
Amortization graduate list	57,925
Total Disallowed	$974,578

In the notice of deficiency the claimed depreciation for the fiscal year of est, a.e.c. ended June 30, 1981, of $598,033 was not disallowed and was not at issue in the case before this Court.

It is clear from our findings in our Memorandum Findings of Fact and Opinion filed July 1, 1991, that leasehold improvements, office furniture, office equipment, audiovisual equipment, other equipment, vehicles, and computer hardware and software were transferred by est, a.e.c. to WEA around July 1, 1981. The record shows that the "Franklin Building" was transferred by est, a.e.c. to WEA around the end of July 1981. It is not clear from the record whether the building and addition listed on the depreciation schedule of est, a.e.c. on its return for its fiscal year ended June 30, 1981, was the Franklin Building which in our Memorandum Findings of Fact and Opinion filed July 1, 1991, we found was transferred to WEA at the end of July 1981.

Petitioners, in an exhibit attached to their brief with respect to their motion for reconsideration, submitted a computation with respect to items transferred by est, a.e.c. to WEA, going back and making adjustments based on returns of est, a.e.c. for the year 1975 forward. However, it appears to us that the remaining basis that est, a.e.c. had in the building and addition, leasehold improvements, office furniture, and the other items listed on the schedule attached to est, a.e.c.'s return for its fiscal year ending June 30, 1981, should properly be determined by subtracting from the cost or other basis of these assets in the hands of est, a.e.c. the amount of accumulated depreciation and current depreciation shown on the schedule. We do notice that on this same schedule the leasehold improvements of $934,442 are shown as sold or abandoned as are the items of $123,670 of other equipment and $124,008 of vehicles sold. Apparently this statement was intended to in some way be connected with the transfer by est, a.e.c. of certain items to WEA. However, it appears to us that if the schedule of depreciation of est, a.e.c. is accepted as evidence of the remaining basis of est, a.e.c. in the various assets at the time they were transferred to WEA, that the schedule of transferred or abandoned assets has no relevance.

Having found some evidence of the basis of est, a.e.c. in a number of the assets transferred to WEA shortly before the transfer, we need to discuss: (1) What evidence is available to show that this basis should carry over to WEA, (2) what the useful life of these assets was at the time they were transferred to WEA, and (3) whether there is anything in the record to justify WEA's using for depreciation purposes the remaining basis of the assets in the hands of est, a.e.c. at the time they were transferred to WEA.

Obviously, in view of the dismissal of the case of est, a.e.c. for its fiscal year June 30, 1981, the portion of the statement dealing with amortization of license and graduate lists sold has no semblance of reliability. However, the leasehold improvements and other items shown on the depreciation schedule appear to be probative evidence of the basis of those items to est, a.e.c.

Petitioners in their income tax return for the calendar year 1981, which is joint Exhibit 1-A in these cases, on Schedule C assigned various useful lives to various pieces of property used in the business of WEA. Also Schedule C of petitioners' returns for 1982 and 1983 show this same information. The items shown on Schedule C of petitioners' returns as capitalized leases are not assets which are shown on the returns of est, a.e.c. for its fiscal year ended June 30, 1981. Therefore WEA would have no depreciable basis in "capitalized leases" based on any carryover basis from est, a.e.c. The graduate lists have not been shown to have a basis to est, a.e.c. or WEA and except for "Building and addition" listed by est, a.e.c. with a cost or other basis of $501,088, no basis for building improvements is shown. It appears that the leasehold improvements with a basis of $331,624 ($934,442 less the $498,668 of accumulated depreciation and the $104,150 of current depreciation) may be allocated useful lives as shown on

Schedule C of petitioners' 1981 return and on this basis depreciation computed for WEA on those assets. The remaining basis of est, a.e.c. in office furniture, audiovisual equipment, other equipment, vehicles, and computer software and hardware may be allocated useful lives in the same manner in order to compute depreciation for each year here in issue and that a similar computation may be made for the "Building and addition" as shown on the return of est, a.e.c. for its fiscal year ended June 30, 1981.

Respondent argues that if we permit petitioners to use the unused basis of est, a.e.c., it is necessary to determine the gain or loss to petitioners from a distribution to them of the est, a.e.c. assets. Under certain circumstances respondent might be correct in this contention. However, here the weight of the evidence seems to be that although returns were filed by est, a.e.c. and its ownership was stated to be in Werner Erhard Charitable Settlement, on the accounting system used by Margolis est, a.e.c., the Werner Erhard Charitable Settlement, and the Erhard's personal accounts were kept as one and intermixed. Effectively the result of this method of bookkeeping was that, regardless of the technical ownership of est, a.e.c. and regardless of the recognition of this ownership in several cases before this Court (*see Erhard Seminars Training v. Commissioner* [Dec. 43,456(M)], T.C. Memo. 1986-526, in which we held that claimed amortization deductions were sham transactions and certain claimed expense deductions were disallowed because they were personal expenses of Werner Erhard and his family and est, *An Educational Corporation v. Commissioner* [Dec. 43,457(M)], T.C. Memo 1986-527, in which we held that a purported indebtedness incurred by the taxpayer in acquiring a 10-year license was a sham transaction and the taxpayer was held not to be entitled to amortization expenses or claimed interest expense deductions) on the Margolis books the two corporations

and the Erhards were treated as one. We referred to the cases of est, a.e.c. for the years 1981 and 1982 in our Memorandum Findings of Fact and Opinion in these cases filed July 1, 1991. In those cases deficiencies as determined by respondent were sustained when the cases were dismissed for lack of prosecution. One of these cases involved the fiscal year ending June 30, 1981, of est, a.e.c. and the other fiscal year of est, a.e.c. ending June 30, 1982. While none of these cases actually held that Werner Erhard and the corporations were in substance one and the same, in all of them the transactions under consideration were considered shams. By determining that the basis of the assets WEA obtained from est, a.e.c. is the remaining basis at June 30, 1981, of est, a.e.c. in those assets, we are not determining whether in fact est, a.e.c. was separate and distinct from Werner Erhard and what the ownership of est, a.e.c. was. We have merely concluded that most of the transactions involving the financial affairs of est, a.e.c., as was the purported purchase in these cases, were sham transactions and for that reason have concluded for the purposes of a basis of WEA in the physical assets which were transferred from est, a.e.c. to WEA, the sole proprietorship of Werner Erhard, the unrecovered basis of est, a.e.c. at the time the assets were transferred to WEA is the basis of WEA in those assets. Our conclusion is that WEA should be entitled to recover through depreciation the unrecovered basis in the depreciable assets of est, a.e.c. transferred to WEA to the extent that, on this record, those assets can clearly be traced as going from est, a.e.c. to WEA and used by WEA in its business of conducting seminars. Upon reconsideration we modify our Memorandum Findings of Fact and Opinion filed July 1, 1991, by allowing depreciation deductions to WEA on the basis outlined herein. We are aware of the fact that the parties in these cases stipulated that est, a.e.c. was a seprate entity from petitioners and WEA. We have considered this

stipulation in reaching our conclusion of the basis of WEA in the assets it received from est, a.e.c. and concluded that considering the unusual facts in this record, WEA did have the basis for depreciation in the assets received from est, a.e.c. which we have found.

The final argument made by petitioners is that under a holding of the Ninth Circuit Court of Appeals we incorrectly determined that petitioners were subject to the addition to tax under section 6661(a) for the years 1982 and 1983. In the case of *Vorsheck v. Commissioner* [91-1 USTC ¶50,258], 933 F.2d 757 (9th Cir. 1991), affg. in part and revg. in part an Oral Opinion of this Court, the Ninth Circuit held that the taxpayer was not liable for the addition to tax under section 6661(a).

In *Vorsheck v. Commissioner, supra,* we held that the taxpayers were not liable for the additions to tax under section 6653(a) since they had relied on the advice of an accountant in claiming deductions with respect to an investment in a limited partnership. We held the limited partnership to be a tax shelter without a profit objective. We held that the partnership did not engage in a trade or business, but was merely organized to offer investors a tax shelter. However, since the taxpayers in the *Vorsheck* case had entered into the transaction on the advice of an accountant in good faith with the objective on their part to make a profit, we concluded that they were not subject to the addition to tax under section 6653(a). We held however that since there was a substantial understatement of income tax, the the taxpayers in *Vorsheck* were subject to the addition to tax under section 6661. The Ninth Circuit pointed out that section 6661(c) provides that the Secretary may waive the "penalty" provided for in section 6661(a) on a showing by the taxpayer that there was reasonable cause for the understatement and that the taxpayer acted in good faith. The court then stated:

> Thus, if it was reasonable for the taxpayer to rely upon the advice of an accountant under the circumstances, and the taxpayer did so in good faith, then the Commissioner may waive the penalty.
>
> Here, the tax court found that, although the fact that WROG was a tax shelter would have been apparent to an "experienced businessman," the Vorshecks were not sophisticated business persons. "[T]hey relied upon the advice of their trusted tax adviser who assured them that they would obtain certain deductions."
>
> On the basis of its evaluation of the motives and experience of the Vorshecks, the tax court denied the penalties under sections 6653 and 6659. The tax court, however, found that the Vorshecks were liable for the penalty under section 6661. We do not agree. If the Vorshecks were acting as "an ordinary prudent person in the circumstances," then their reliance upon the investment advice of their accountant was "reasonable" and "in good faith under all the circumstances." See Treas. Reg. § 1-6661.6(b); *Heasley* [90-1 USTC ¶ 50,314], 902 F.2d at 385. Thus, the Vorshecks meet the standard for waiver of the penalty under section 6661. Accordingly, we reverse the tax court's decision upholding the Commissioner's assessment of a 10% penalty under section 6661. [*Vorsheck v. Commissioner, supra* at 759; fn. ref. omitted; citation omitted.]

In the instant case we found that petitioners' reliance on the advice of lawyers and accountants in following the plan of taking over the assets of est, a.e.c. was reasonable and in good faith. However, for reasons we explained in the opinion, we did not consider that these same facts required a con-

clusion that the taxpayers were not liable for the addition to tax under section 6661. However, we see no distinction in the instant case and the case of *Vorsheck v. Commissioner, supra*. Since an appeal in the instant case lies to the Ninth Circuit, we reconsider our opinion with respect to the section 6661 addition to tax, and based purely on the holding of the Ninth Circuit in the case of *Vorsheck v. Commissioner, supra*, conclude that because petitioners' reliance on their lawyers and accountants with respect to the transactions here involved was reasonable and in good faith, petitioners met the standard for waiver of the addition to tax under section 6661. Accordingly, we hold that petitioners are not liable for the addition to tax under section 6661. Except in the two respects outlined above we reaffirm our holding in all respects as set forth in our Memorandum Findings of Fact and Opinion filed July 1, 1991.

An order denying in part and granting in part petitioners' motion for reconsideration will be issued and decisions will be entered under Rule 155.

APPENDIX F

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T.C. Memo. 1991-290

UNITED STATES TAX COURT

WERNER H. ERHARD and ELLEN V. ERHARD,
Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

Docket Nos. 39473-85, 46712-86, 39532-87, 137-88. Filed July 1, 1991.

Michael I. Saltzman, Barbara T. Kaplan, and *Robert F. Hermann,* for the petitioner.

Carmen Baerga, Craig Connell, Mildred Moon, and *Ray Kahn,* for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

SCOTT, *Judge:* These consolidated cases were assigned for trial or other disposition to Special Trial Judge James M. Gussis pursuant to section 7443A(b) of the Internal Revenue Code and Rule 180 et seq.[1] This Court Agrees with and adopts the opinion of the Special Trial Judge which is set forth below.

OPINION OF THE SPECIAL TRIAL JUDGE

GUSSIS, *Special Trial Judge:* Respondent has determined the following Federal income tax deficiencies, increased interest and additions to tax:

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[1]All section references are to the Internal Revenue Code of 1954 as amended and in effect for the years in issue unless otherwise indicated. All Rule references are to the Tax Court Rules of Practice and Procedure.

Depreciation As Computed Under Federal Statutes

Statement 8 — Depreciation

Non-Recovery Property

Description	Date Acquired	Cost Or Other Basis	Accumulated Amortization	Method	Useful Life Yrs Pct	Current Amortization
Building & Addition	02/01/77	501,088	17,054	SL	VAR	5,767
Leasehold Improvements	VAR	934,442	498,668	SL	VAR	104,150
Office Furniture	VAR	853,323	328,403	SL	VAR	117,324
Office Equipment	VAR	369,407	160,402	SL	VAR	53,339
Audio Visual Equipment	VAR	405,503	241,058	SL	VAR	68,423
Other Equipment	VAR	650,962	117,730	SL	VAR	88,553
Vehicles	VAR	124,008	60,274	SL	VAR	31,369
Software	VAR	179,390	38,555	SL	VAR	55,522
Hardware	VAR	358,489	67,281	SL	VAR	73,586
Leasehold Improvements —Sold or Abandoned	VAR	-934,442	-498,668			0
Other Equipment — Sold or Abandoned	VAR	-123,670	-12,634			0
Vehicles — Sold	VAR	-124,008	-60,274			0
Totals		3,194,492*	957,849*			598,033*
Total Depreciation						598,033*

Docket Nos.	Year	Income Tax Deficiency	Increased Interest and Additions to Tax Sections			
			6621(c)	6653(a)(1)	6653(a)(2)	6661
39473-85	1981	$456,431.00	—	$22,822.00	*	—
46712-86	1982	747,413.50	Applicable	37,676.00	**	$ 75,352.00
39532-87	1983	494,446.00	Applicable	24,722.00	***	123,612.00
137-88	1983	494,446.00	Applicable	24,722.00	***	123,612.00

*50 percent of the interest due on the underpayment of $456,431.00 attributable to negligence.
**50 percent of the interest due on the underpayment of $747,413.50 attributable to negligence.
***50 percent of the interest due on the underpayment of $494,446.00 attributable to negligence.

On November 1, 1988, the Court granted respondent's motion in docket No. 39473-85 to increase the interest rate on the underlying deficiency for the year 1981 pursuant to section 6621(c). In an amendment to his answer in docket No. 46712-86 respondent claimed an increased addition to tax under section 6661 of 25 percent of the underpayment for the year 1982, or $186,853.37.

Petitioner Ellen V. Erhard did not appear at the trial of these cases. On March 23, 1989, she filed with the Tax Court an Agreement to be Bound by the decision of the Tax Court in these cases.

The issues, which were consolidated for purposes of trial, briefing and opinion, are (1) whether petitioners are entitled to an interest expense deduction in 1981 with respect to certain purported loans from Terla, B.V.; (2) whether petitioners are entitled to an interest expense deduction in 1981, 1982 and 1983 with respect to a purported $14,000,000 loan from Intercultural Cooperation Foundation; (3) whether petitioners are entitled to an interest expense deduction in 1982 with respect to a purported $1,000,000 loan from Intercultural Cooperation Foundation; (4) whether petitioners have established a basis for depreciation purposes in 1981, 1982, and 1983 in the assets purportedly acquired from est, an educational corp., the Werner Erhard Charitable Settlement, Associated Advisors, Presentaciones Musicales, S.A., and Welbehagen; (5) whether petitioners are liable for the additions to tax under section 6653(a)(1) and (2) in 1981, 1982, and 1983; (6) whether petitioners are liable for additions to tax under section 6661 in 1982 and 1983; and (7) whether petitioners are liable for the increased interest under section 6621(c) in 1981, 1982, and 1983.

BEST AVAILABLE COPY

FINDINGS OF FACT

Some of the facts were stipulated and they are herein incorporated by this reference. Werner H. Erhard (sometimes referred to herein individually as petitioner) was a resident of Sausalito, California, and petitioner Ellen Erhard was a resident of Novato, California, at the time the petitions herein were filed. Petitioners timely filed joint Federal income tax returns for the years 1981, 1982, and 1983 with the Fresno Service Center.[2]

Werner Erhard is the proprietor of Werner Erhard & Associates (hereinafter WEA) which was formed in 1981 to offer seminars, workshops and other programs in personal effectiveness to the public. Prior to the formation of WEA, a variety of programs, seminars, workshops and lectures concerned with personal effectiveness were offered to the public by est, a.e.c. The major program marketed by est, a.e.c. was the est training program which involved the effective delivery of certain ideas, concepts and know-how embodied within the collective term, the Body of Knowledge. The Body of Knowledge was created by Werner Erhard, who was also the original developer of the est training. Erhard continued as the primary developer of the training and he decided when a particular trainer was qualified or capable of leading the training. Erhard received W-2 income from est, a.e.c. in the years 1975 through early 1981. Prior to the formation of WEA in 1981, est, a.e.c. had between 300 and 350 employees and owned the requisite business assets for its operations such as leaseholds, leasehold improvements and computer equipment.

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[2]The use of such words as "borrow," "loan," "interest," "purchase," and "payment" in our findings of fact is for narrative convenience, describing the form of the transaction, and is not intended to indicate any conclusion concerning the actual substance of the transaction in question.

By 1980, the est training program had been delivered to between 250,000 and 300,000 individuals. The various services provided by Erhard were indispensable to the effectiveness and profitability of the est, a.e.c. operations.

Harry Margolis became the personal legal and financial advisor for Werner Erhard in 1971, in which year Margolis also arranged for the formation and financing of Erhard Seminars Training, Inc., for the purpose of presenting seminars to the public. These seminars were based upon concepts which Werner Erhard originated and which became known as the Body of Knowledge. Margolis became legal advisor to Erhard Seminars Training, Inc., and handled the accounting and financial aspects of the corporation. The activities of Erhard Seminars Training, Inc., were subsequently taken over in 1975 by a new corporation, est, a.e.c., a corporation formed under the laws of Nevada.

The stock of est, a.e.c. was held by the Werner Erhard Charitable Settlement, an entity formed under the laws of the Channel Island of Jersey. Alexia Trust Co. was the trustee for the Werner Erhard Charitable Settlement. The Werner Erhard Charitable Settlement, together with a charitable organization in Switzerland called the Werner Erhard Foundation for est, a.e.c., owned a holding company in Switzerland, WEF est Holding, A.G., which in turn owned a company in the Netherlands called Welbehagen, B.V.

Margolis devised the financial and legal structure of est, a.e.c. and continued in his involvement and tax planning for the new corporation. Margolis was the legal and financial advisor, tax return preparer, banker and accountant for est, a.e.c. between 1975 and 1981. For the most part, the employees of Erhard Seminars Training, Inc., continued in the employment of est, a.e.c.

Under agreements prepared by or at the direction of Margolis, effective September 1, 1975, Presentaciones Musicales, S.A. (PMSA), a Panamanian Co., sold the Body of Knowledge to Welbehagen, B.V., which licensed the Body of Knowledge in the United States to est, a.e.c. and to organizations in other countries. Under this arrangement, est, a.e.c. deducted amortization and interest paid to Welbehagen. est, a.e.c. received funds of capital contributions from Werner Erhard Charitable Settlement.

est, a.e.c., with headquarters at 765 California Street in San Francisco, California, was managed by professional and fully qualified managers. In 1980, there were centers in some 30 cities throughout the United States managed by local managers who reported to headquarters through area managers. Personnel matters, administration, communications, training programs and international operations were managed from headquarters. A division of est, a.e.c. called the office of Werner Erhard was located at the Franklin House at 1945 Franklin Street in San Francisco, with its own staff of aides, communicators and administrative personnel.

The members of the office of Chief Executive and other executives made up an executive group which oversaw the operations of seven divisions: Centers management, international, communications, personnel, the academy, administration and the office of Werner Erhard.

The delivery of programs by est, a.e.c. was seasonal in nature, with business operations running in trimesters beginning in February, June and October. Revenues were highest in the trimester from June through September. The trimester beginning in October was the seasonal low. For its fiscal year ended June 30, 1980, est, a.e.c. reported gross receipts from operations in the amount of $23,368,328 and, after deductions

which included amortization and interest expense deductions, reported zero taxable income.

The Harry Margolis system was a group of off-shore and domestic corporations, trusts, banks, partnerships and other entities used by Margolis to implement his tax planning for clients. A system entity refers to an individual entity within the system. System entities were controlled either directly or indirectly by Margolis, his law office or his employees. System entities included the following: Alexia Trust Co., (hereinafter Alexia); Antigua Banking, Ltd.; Aruba Bonaire Curacao Trust Co., (hereinafter ABC Trust); Associated Advisors; Erik Holding Co.; Island Bank (British Virgin Islands) Ltd., (hereinafter Island Bank, Ltd.); Kempold, B.V.; Mator, S.A.; Mundial Investment; Parallax Corp., a Panamanian Corp.; Presentaciones Musicales, S.A. (hereinafter PMSA); Sineuri, S.A., a Panamanian Co.; Terla, B .V.; Truma, B.V., a Netherlands Co.; Welbehagen, B.V.; Werner Erhard Charitable Settlement; and Werner Erhard Foundation for est, a.e.c.

Erik Holding, B.V., Terla, B.V., and Kempold, B.V., were sysems entities registered in the Netherlands that provided almost identical functions in the Harry Margolis system. The system entities served identical functions in that they processed loans for individuals and entities who generally were clients of Margolis. With respect to the functions of Island Bank, Ltd., almost all of its customers were affiliated with Margolis. Island Bank, Ltd., itself did not make loans. Instead, Island Bank, Ltd., made funds available to overseas system entities which in turn would make the actual loans. The process by which Island Bank, Ltd., made funds available to an overseas system entity followed a standard procedure in the operation of the Harry Margolis system. Generally, the overseas system entity would agree to make a loan and Island Bank, Ltd., would

then provide the necessary financing by making the funds available to the lending entity. The lending process would be initiated by a request from the office of Harry Margolis. Island Bank, Ltd., and the lending entity would both be managed by Mator, S.A., and the same individuals would act for both. Mator, S.A., was a trust management company providing accounting, adminsitrative, statutory and other related services for corporate entities.

The representation of clients in the office of Harry Margolis generally consisted of (1) an initial phase during which the client's goals were defined and documents were drafted to realize such goals; and (2) an implementation stage during which the required relationsips were established; and (3) a so-called clean-up phase when the client desired to terminate the contractual relationships which were then phased out. Where required, money movements would be made in order to complete the clean-up phase.

The est, a.e.c. organizational structure devised by Margolis in 1975 was a maze of intertwined organizations with numerous agreements among the entities involved. After est, a.e.c. was formed by Margolis in 1975, he created system entities which dealt only with est, a.e.c. These system entities included Welbehagen, B.V., Werner Erhard Charitable Settlement, the Werner Erhard Foundation for est, and WEF est Holding, A.G. Welbehagen, B.V., was an entity in Holland; Werner Erhard Charitable Settlement was situated in the Isle of Jersey; Werner Erhard Foundation for est and WEF est Holding, A.G., were Swiss entities; est, a.e.c. was a Nevada Corp. Alexia, the trustee of Werner Erhard Charitable Settlement, was a trust company situated in the Isle of Jersey.

Werner Ehard Charitable Settlement, in addition to owning all of the stock in est, a.e.c., also held an interest in the Swiss holding company, which in turn owned all of the stock in Welbehagen, B.V.

The gross profits reported by est, a.e.c. in the taxable years ended June 30, 1975, through 1981 were in the following respective amounts: $7,294,742, $9,322,668, $11,271,827, $14,956,956, $17,155,518 and $15,510,121. During this entire period est, a.e.c. reported total taxable income of approximately $100,000.

In the course of the management by Margolis of the financial affairs of Werner Erhard, Erhard incurred an indebtedness of about $1,000,000 to Barclays Kol in the Netherlands and also incurred financial obligations to the system entities Associated Advisors and Antigua Banking, Ltd.

In 1976 Margolis was indicted on criminal tax charges arising from his tax planning activities. He was acquitted of all charges in 1977. After the indictment of Margolis, Erhard and his executives became concerned over the impact on their business operations in view of the role played by Margolis in such operations.

On or about January 11, 1980, Werner Erhard announced his initiation of a project to reexamine and analyze the legal, financial and organizational structure of est, a.e.c. and its predecessor, Erhard Seminar Training, and the formation of a task team to implement the project. The task team was composed of several est, a.e.c. executives and staff members and other professionals in the fields of law and management. The purpose of the project was to "create est anew." In April 1980 the est organization was informed of the formation of a new office of Chief Executive within est, a.e.c. All of the legal, financial, accounting, banking and tax work for both Erhard Seminar Training and est, a.e.c. had been conducted by Margolis. Neither Erhard nor the est, a.e.c. executives had a clear understanding of the maze of foreign and domestic entities, all associated with Margolis, that surrounded est, a.e.c. Nor did Erhard have a complete and accurate understanding of his personal financial situation in early 1980. In May 1980

Margolis, in a memorandum to Charles O. Johnston, an est, a.e.c. executive, outlined his recommendations concerning the distribution of 10-year bonuses to est, a.e.c. employees. In a May 8, 1980, memorandum Erhard advised the est staff that, together with Margolis and the task team, Erhard had for some time been examining the role of est's legal counsel in the project to "create est anew", and had now jointly determined to replace the Harry Margolis office as the general and tax counsel of est, a.e.c.

In a memorandum dated April 30, 1980, from Margolis to Ellie M. Deull, and attorney for est, a.e.c. and for Werner Erhard personally, Margolis indicated his understanding with Werner Erhard that the office of Harry Margolis would be responsible for the tax matters of est, a.e.c. through June 30, 1980. With respect to the period after July 1, 1980, Margolis indicated in the memorandum that in the event "our structure is utilized, we expect to collect fees and costs as in the past." In a memorandum to Deull dated May 24, 1980, Margolis stated that at the time est, a.e.c. was formed in 1975, it was contemplated that the new corporation would probably not remain in existence for more than three years.

Prior to 1981, the office of Harry Margolis maintained a so-called system accounting for the clients of Margolis which recorded funds flowing into the system from the client or non-system entities and funds flowing out of the system to the client or non-system entities. The system accounting was a chronological history of the transactions of a client within the system and kept track of the client's balance, either positive or negative, within the system. All funds flowing into the system from a client or a non-system entity were entered in the system accounting as a credit while all funds flowing out of the system to a client or a non-system entity were entered in the system accounting as a debit. A client earned

interest on positive balances in the system accounting maintained for him and was charged interest on negative balances. Transactions between system entities were not recorded in the system accounting since the funds stayed within the system. The office of Harry Margolis maintained only one combined system accounting for Werner Erhard and est, a.e.c.

Inez Teague was employed in the office of Harry Margolis in 1971 as a staff accountant and then undertook the duties of coordinating the banking activities of the office. Her employment continued with the office until 1984. Paul T. Mason was a business associate of Margolis and was managing director of Island Bank, Ltd., and Sineuri, S.A., in Panama. Prior to 1982, he also managed Mator, S.A., a trust management company that provided management services to various corporate entities. Such services included accounting, administrative, and other statutory services required under government regulations. Most of the Mator, S.A., clients were corporations that had dealings with Margolis and attorneys currently or previously associated with him. Everd B. van Walsum was a business associate of Margolis. During the year 1981 van Walsum was president of Mator, S.A. He was also the managing director of Alexia and Truma, B.V.

Arthur H. Schreiber was house counsel for est, a.e.c. from 1979 to 1981. In June 1981 he became general counsel to WEA and since the middle of 1987 he has been the chief operating officer fo WEA. During the period from about February 20, 1981, to May 31, 1981, Schreiber served in the dual capacity as an employee of est, a.e.c. and as an associate of WEA.

Michael Eisenberg was an executive in the accounting office of est, a.e.c. from September 1978 through May 1981. He was employed by WEA in various financial capacities from June 1981 through February 1988. Johnston was employed as chief financial officer for est, a.e.c. in or about Janaury 1980,

and in June 1981 he commenced employment with WEA. He left WEA in or about May 1982. Robert R. Curtis was employed in various executive capacities by est, a.e.c. until May 31, 1981, when he became employed by WEA. Pat Dillan was employed in an administrative capacity in the chief executive office of est, a.e.c. in 1979 and 1980. In or about September 1980 she was assigned to the office of Werner Erhard within the est, a.e.c. organization as project manager and in 1981 she continued in that capacity for WEA. Myron A. Wick was manager of the office of Werner Erhard and then chief executive officer of est, a.e.c. during the period from 1980 until May 1981. In June 1981 he became chief executive officer of WEA until he resigned from WEA in September 1983.

Brown Educational Corp. (hereinafter BEC) was formed in or about September 1981 as a holding company and an educational service company for sales organizations. BEC did not implement its stated purpose of acting as an educational service company. Am-Pro Marketing, Inc., (hereinafter Am-Pro) is a sales and marketing company primarily engaged in marketing a fuel additive product manaufacured by Bell Laboratories in Florida. BEC filed a petition in bankruptcy in 1985 or 1986. Johnny Brown was president of both BEC and Am-Pro. Glenn J. Beadle was employed by Am-Pro as a motivational speaker and as the adminstrator of the company. Beadle was also an officer, director and shareholder of BEC. John D. Singleton, an attorney in Oklahoma, was retained by Am-Pro to perform tax-planning services. In 1980 and 1981, Singleton, together with Beadle, consulted Margolis with respect to tax-planning. Kenneth H. Reiserer, a California attorney employed in the office of Harry Margolis from 1973 to 1976 and later from June 1977 to about January or February 1981, also participated in the tax-planning for Am-Pro. Am-Pro eventually entered into certain contractual arrangements

suggested by the office of Harry Margolis involving Sineuri, S.A., and Truma, B.V.

The Harry E. Wright, Jr., Charitable Trust was established on May 24, 1971, by Margolis pursuant to the will of Harry E. Wright, Jr. John E. Thorne, a California attorney, was a trustee of the Harry E. Wright, Jr., Charitable Trust.

The First National Bank of Boston, Panama, was a branch of the First National Bank of Boston, a national bank chartered in the United States.

Margolis, in the implementation of his tax planning for clients over the years, devised orchestrated cash flows or money movements that were structured by contractual arrangements. To create these money movements, Margolis on occasion would obtain the use of certificates of deposit for a fee from est, a.e.c. for a few days to use as collateral in obtaining the temporary use of funds for the money movements. When the cash flow was completed, usually in a brief period of time, the collateral was released and the certificates were returned to est, a.e.c. Generally transaction requests and check requests were used in the office of Harry Margolis to implement pre-arranged money movements. Transactions involving money movements would be accumulated and executed at the same time. These transactions would be coordinated by a designated employee in the office of Harry Margolis.

In March 1980, Pat Dillan, an administrator in the chief executive office of est, a.e.c., conducted a survey of the advisory board of est, a.e.c. to ascertain, inter alia, the attitudes of the board members toward the legal and financial structure of est, a.e.c. In August 1980, the board members were apprised of the results of the survey, which emphasized the view that the complexities of the legal and financial structure of est, a.e.c. were difficult to understand and engendered skepticism from the public.

In late 1979 or 1980 est, a.e.c. retained Deull (see *supra* p. 11), who in conjunction with the ongoing "create est anew" project, undertook to investigate the legal and financial structure of est, a.e.c. and to explore the various legal and financial aspects of a transaction from est, a.e.c. to a new organization. Deull, in additions to his legal services for est, a.e.c., also performed personal legal services contemporaneously for Werner and Ellen Erhard. He ceased representing est, a.e.c. in January 1981 and began representing WEA in February 1981. He continued to represent WEA until October 1984.

Deull was a member of the est, a.e.c. advisory board which consisted of approximately 50 professionals and individuals who had participated in programs delivered by est, a.e.c. During the pendency of the criminal case involving Margolis, Deull expressed to Werner Erhard the view that the structure created for est, a.e.c. by Margolis was unduly complicated, confusing and anti-ethical to the work conducted by Werner Erhard and that the association with Margolis would, with respect to certain segments of the community, have a negative impact on the growth potential of est, a.e.c. The est, a.e.c. executives were also dissatisfied with the involvement by Margolis in the management and operation of est, a.e.c.

Margolis was made aware of the task team and his cooperation was sought in providing information and materials necessary for the completion of the investigation. Margolis was also informed of the retention of Deull, van Merkensteijn and Seth Hufstedler, an attorney, as outside legal counsel for est, a.e.c. and of the intention to eventually relieve the Margolis office of any ongoing responsibility. The initial offer of Margolis to resign immediately from the est, a.e.c. account was rejected by Deull.

Deull retained John van Merkensteijn, an attorney, to analyze the tax aspects of the existing legal structure of est,

a.e.c., to recommend a future structure for the ongoing business operation and to recommend suitable methods for the transition to the new structure. One of the concerns of van Merkensteijn was the avoidance of any transferee liabilities resulting from the transfer of assets from est, a.e.c. to any new business organization. John van Merkensteijn was subsequently retained as counsel by est, a.e.c. On April 25, 1981, he resigned as counsel to est, a.e.c. William C. Gifford, an attorney, was contacted by van Merkensteijn in 1980 to assist in the tax aspects of the transition form est, a.e.c. to a new entity. Gifford later became the personal attorney for Werner Erhard and Ellen Erhard and, on or about April 25, 1981, he became tax counsel for WEA.

During the spring and summer of 1980, Deull and other attorneys examined possible ways of reorganizing the est, a.e.c. enterprise. Among the alternatives they considered were a sole proprietorship, a corporation and a combination of a sole proprietorship with a section 501(c)(3) organization. In August 1980, Deull and van Merkensteijn recommended to Werner Erhard and the est, a.e.c. executives that Erhard should conduct the enterprise in the future as a sole proprietorship. In a memorandum to Werner Erhard dated September 16, 1980, Deull and van Merkensteijn explained their recommendation as follows:

* * *

> The difficulty with the present situation is that it is (1) technically complex, (2) difficult, if not impossible to explain or understand and (3) subject to both public criticism and litigation with the Internal Revenue Service. Overall, many perceive it as acting as a barrier to your effectiveness.
>
> If we intend to deal the death blow to these perceptions and problems, we want a legal and finan-

cial structure which is simple, easy to explain and honest, one which can be understood by anyone and which is morally right, ethical and consistent with purpose. If we have no intention or purpose to be at loggerheads with the tax system, the structure should be one in which substance and form are the same, in which both truth and reality correspond, which expresses the quality of integrity, and which not only permits you and the organization to function without hindrance but facilitates such functioning.

From the tax point of view, the reflection of your perceived intention will be through one of three alternative structures:

1. no structure (everything in a sole proprietorship and fully subject to tax);

2. everything in a charitable organization and not subject to tax;

3. a coordinated combination of (1) and (2).

Choice (1) from the tax point of view is truly participating in a death blow to the current organizational ethic that beating the tax system is the objective of "planning" and a necessity for survival. This puts no box around any activities, is consistent with you as source, supports and allows everything you have said you intend or want to do to happen without hindrance. While it may not be easy or even possible to get there, it is the direction in which we believe you should go. As we discussed on August 19, it has non-tax considerations which are that you will be seen to be making the money (although you can avoid being seen to be wealthy by giving it away)

> and it will be inconsistent with previous public statements (such as the 1976 Legal-Financial Letters) and these may effect your ability to accomplish and contribute.

In the September 16, 1980, memorandum to Werner Erhard, the attorneys also stated:

> The existing legal and financial structure of est is and has been consistent with your intention to own est by giving it away; a structure consistent with your desire not be seen to be "in it for the money" while maximizing your ability to expand your contribution to people's well-being and the transformation of the quality of their lives.

* * *

> In our paradigm, it is only possible to either be seen making the money and therefore being able to dispose of it, or not to be seen making the money and not being able to dispose of it or having it; and it is not possible within our system *not* to be seen making the money and having control or power to dispose of it. That option only exists in the present situation and, of course, leaving everything essentially as it is, is a choice that can still be made.

In October 1980, a discussion group of some six tax attorneys, including Gifford, which had been formed by van Merkensteijn in the mid-1970s, met in the Franklin House in San Franscisco. A topic of discussion was the restructuring of the business operations of est, a.e.c. and how Werner Erhard and the business enterprise could leave the Margolis system. The consensus of the group was that the association of Margolis with est, a.e.c. was a commercial impediment to

the operation of the enterprise, that a purchase of the business assets from est, a.e.c. for fair market value was the best vehicle for obtaining the needed assets to continue the business operations in a new form, and that a sole proprietorship was the best alternative for enabling Werner Erhard and the enterprise to operate free of Margolis.

The recommendation of Deull and van Merkensteijn to continue the enterprise as a sole proprietorship was accepted by Werner Erhard and the est, a.e.c. management with the expectation that the est, a.e.c. management and employees would become employees of the sole proprietorship. John van Merkensteijn advised that a valuation of the business and the assets of est, a.e.c. should be obtained.

A Settlement and Consulting Agreement was entered into by est, a.e.c. and Werner Erhard effective as of December 31, 1980, pursuant to which Erhard terminated his employment relationship with est, a.e.c., entered into a consulting agreement with est, a.e.c., and confirmed the retention by Erhard of his individually owned programs which he had permitted est, a.e.c. to market and deliver.

John van Merkensteijn did not know of the Barclays Kol back-to-back loan to Werner Erhard which was collateralized by the Werner Erhard Charitable Settlement. Van Merkensteijn recommended that the Body of Knowledge materials be devalued, notwithstanding the fact that est, a.e.c. had contracts with Welbehagen, B.V., to pay $1,000,000 a year for the Body of Knowledge. In June 1980, van Merkensteijn recommended that the personal assets held by systems entities be acquired by Werner Erhard personally.

In view of the key role of Werner Erhard in the services offered by the est, a.e.c. organization, the departure of Erhard together with some of his executives and trainers would de-

prive the est, a.e.c. organization of its capability to function and to produce income and would leave the organization with nothing other than real estate, rental obligations and a miscellany of hardware.

WEA was formally established as a sole proprietorship under California law in February 1981. A series of agreements effective as of February 20, 1981, was entered into by WEA and est, a.e.c. which established interim arrangements governing the administration, marketing, consulting and employee service associated with the business of WEA. In large part, the agreements were intended to compensate est, a.e.c. for administrative services associated with the business of WEA, for program enrollment marketing services performed by est, a.e.c., and to compensate WEA for services by its employees for est, a.e.c. Eisenberg, director of finance of WEA, prepared interim accounting procedures for the sole proprietorship, established separate books and records and opened new book accounts.

In planning the acquisition of the est, a.e.c. assets by Werner Erhard, attorneys van Merkensteijn, Gifford and Deull recommended in April 1981 that Werner Erhard acquire the assets through leases. In a memorandum dated April 23, 1981, to Margolis, counsel included this recommendation in a list of some 18 steps to accomplish the transfer of the est, a.e.c. assets to WEA. On or about April 25, 1981, the lease plan was presented to the est, a.e.c. executives by van Merkensteijn. The executives rejected the lease plan largely because of concerns over an insufficient cash flow to meet the required lease obligations. An alternative approach calling for the purchase of the assets from est, a.e.c. was then considered by the executives. Margolis supported the purchase alternative and suggested that the assets could be purchase with funds borrowed at low cost and with no interest. It was deemed

essential by the parties to complete the purchase by the end of May prior to the start of the high revenue period, June through September. On or about April 25, 1981, Gifford replaced van Merkensteijn and assumed responsiblity as outside tax counsel for WEA and Erhard personally. The final decision to adopt the asset purchase plan was reached by WEA about the middle of May 1981.

In accomplishing the transfer of est, a.e.c. assets to WEA, the attorneys Gifford, van Merkensteijn and Deull made other recommendations which were not followed by WEA. Counsel recommended that WEA not purchase the existent rights to the Body of Knowledge held by est, a.e.c. or by any other party. However, WEA agreed to purchase the Body of Knowledge. Counsel recommended that the Werner Erhard Charitable Settlement contribute its ownership of est, a.e.c. to a domestic section 501(c)(3) organization. However, at the completion of the asset transfer to WEA, Margolis and his system entities were left in control of est, a.e.c.

In addition to the assets acquired by WEA from est, a.e.c. needed for WEA to operate its business, WEA also purchased personal assets for Werner Erhard, such as the auxiliary sloop, Sirona, from Associated Advisors. Associated Advisors had previously purchased, in addition to the Sirona, an automobile to be used by Werner Erhard, held the unrecorded mortgage on the home of Werner Erhard, had made loans to Werner Erhard, and had provided funds to Werner Erhard for use in the so-called Breakthrough racing activities in or about 1979. WEA also purchased art works from the Werner Erhard Charitable Settlement during the period of the asset transfer from est, a.e.c. to WEA in 1981.

Gary Grace was financial officer for est, a.e.c. at the time he left the organization in 1979. In late 1979 or early 1980, Werner Erhard retained Gary Grace to conduct an investiga-

tion of Erhard Seminars Training and est, a.e.c. and the system accounting in order to ascertain the financial situation of both entities as well as the personal financial situation of Werner Erhard vis-a-vis the Margolis system. Grace was given access to all financial records and files in the office of Harry Margolis which pertained to the entities Erhard Seminars Training, Inc., and est, a.e.c. as well as to Werner and Ellen Erhard in their individual capacities. In his analysis of these records, Gary Grace did not separate the entities and the individuals involved. In his investigation, Grace traced funds going into the system and coming out of the system. Funds moving between system entities were not recorded in systems accounting and Gary Grace was not concerned with such movement of funds. Since the investigation entailed a study of all the relevant records at the Margolis office, Gary Grace conducted the investigation in the capacity of consultant to Margolis. The records examined included the records of Erhard Seminar Training, est, a.e.c., and the records pertaining to Ellen and Werner Erhard. At some point, at the insistence of Deull, Gary Grace continued the investigation under a fee arrangement with the Deull law firm. In all, the entire project conducted by Gary Grace lasted over a period of some nine months.

Grace determined that all amounts paid by est, a.e.c. during the relevant period into the Margolis system were properly recorded as receipts in the Erhard system accounting. Gary Grace also determined that these payments by est, a.e.c. into the system were expended for the benefit of Werner Erhard and est, a.e.c. After September 1, 1975, est, a.e.c. made interest and principle payments to Welbehagen, B.V., and also made payments of legal fees and costs to Margolis. These amounts were credited to the Erhard accounting. Payments from Werner Erhard Charitable Settlement to est, a.e.c. (generally as capital contributions) were charged to the Erhard accounting. Payments from Werner Erhard Charitable

Settlement to purchase art were charged to the Erhard accounting. Payments from Associated Advisors to purchase the auxiliary sloop, Sirona, were charged to the Erhard accounting. Payments from Welbehagen, B.V., to pay for Werner Erhard's travel expenses on a Bali/India trip and his sabbatical expenses were charged to the Erhard accounting. Payments from Associated Advisors to purchase a Porsche automobile for Werner Erhard and to pay his automobile racing expenses were charged to the Erhard accounting. Payments from Welbehagen, B.V., to finance deficits of the foreign operations of est, a.e.c. were charged to the Erhard accounting. Payments made from the Werner Erhard Charitable Settlement for donations by Werner Erhard were charged to the Erhard accounting. On occasion, the system made back-to-back collateral deposits for loans to est, a.e.c.

The result of the analysis performed by Gary Grace was recommendations and questions to be resolved as to the system accounting. In 1982 Werner Erhard and Margolis entered negotiations concerning outstanding balances due between the parties. A settlement was eventually reached in which no payments were required by either party.

On or about May 22, 1981, Teague, an employee of Margolis, was given a special power of attorney by the Parallax Corp., empowering her to open a bank account for Parallax Corp., with Barclays Bank of San Francisco, to pledge funds in the Parallax Corp. account to secure a loan or loans made by the bank to Werner Erhard or WEA, and to perform other functions related to this specific transaction. On June 1, 1981, Parallax Corp. provided general security agreements to Barclays Bank of San Francisco and Barclays Bank International, Ltd., to secure the loans to WEA. In a memorandum termed "cash flow" dated May 20, 1981, Margolis advised Michael Eisenberg, who had the responsibility for drawing checks and arranging transfers of funds for WEA, on aspects

of the financing and the various transactions associated with the transfer of operations from est, a.e.c. to WEA in mid-1981. Check requests and cash receipt forms, which were generally employed by the office of Harry Margolis in documenting cash flows and money transfers in its tax-planning transactions, were used in connection with aspects of the asset transfer in mid-1981 from est, a.e.c. to WEA.

The transfer of assets in mid-1981 from est, a.e.c. to WEA involved the following money movements:

1. On May 27, 1981, WEA made transfers of $16,000 and $250,000 to Associated Advisors.

2. On May 28, 1981, est, a.e.c. transferred $4,657,000 to Welbehagen, B.V.

3. On May 29, 1981, WEA transferred $100,000 to Alexia.

4. On May 29, 1981, WEA transferred $50,000 to PMSA.

5. On June 1, 1981, Parallax Corp. made separate transfers of $1,000,000 and $4,000,000 to Barclays Bank of San Francisco.

6. On June 1, 1981, Barclays Bank of San Francisco made a loan of $5,000,000 to WEA. The total of $5,000,000 transferred by Parallax Corp. to Barclays Bank of San Francisco on June 1, 1981, guaranteed the loan made by Barclays Bank of San Francisco to WEA.

7. On June 1, 1981, Terla, B.V., transferred $2,200,000 to WEA.

8. In June 1981 WEA transferred $2,706,792 to est, a.e.c.

9. On June 1, 1981, WEA transferred $1,602,847.22 to Barclays Kol in the Netherlands in repayment of a loan from Barclays Kol.

10. On June 2, 1981, Alexia transferred $610,000 to est, a.e.c.

11. On July 22, 1981, WEA transferred $765,038 to Alexia.

12. On August 27, 1981 , est, a.e.c. made three transfers to Welbehagen, B.V., in the following amounts: $1,571,000, $1,000,000 and $2,000,000.

13. On August 27, 1981, est, a.e.c. transferred $1,115,000 to Alexia.

14. On August 27, 1981, Alexia transferred $1,390,000 to est, a.e.c.

15. On August 27, 1981, Terla, B.V., made transfers of $2,300,000, $780,000 and $3,500,000 to WEA.

16. On August 27, 1981, WEA transferred $3,693,868 to est, a.e.c.

17. On August 27, 1981, WEA transferred $1,385,000 to Island Bank, Ltd., for the account of Welbehagen, B.V.

18. On August 27, 1981, WEA transferred $213,000 to est, a.e.c. for Associated Advisors.

19. On August 24, 1981, WEA made transfers to Antigua Banking, Ltd., in the amounts of $94,449.47, $342,829, $2,100,000 and $900,000.

20. On August 28, 1981, Antigua Banking, Ltd., transferred $3,000,000 to WEA.

In the May 20, 1981, "cash flow" memorandum from Margolis to Eisenberg, Margolis indicated that when all the contemplated transactions were concluded, the cash position of est, a.e.c. would be reduced by $2,950,000 and the cash holdings of WEA would increase by the same amount.

In 1977 or 1978, Barclays Kol made a loan of $1,000,000 to Werner Erhard. The Barclays Kol loan was secured by a back-

to-back collateral deposit from the Werner Erhard Charitable Settlement. The Erhard accounting in the Harry Margolis sysem of accounting was charged $1,000,000 for the Barclays Kol loan. The Erhard accounting was credited for interest earned for one year on the $1,000,000 collateral deposit made at Barclays Kol for the Barclays Kol loan. In his report to Deull dated June 13, 1980, summarizing his review of the financial interactions of the Harry Margolis office with Werner Erhard, est, a.e.c. and related entities, Gary Grace recommended that interest for an additional year be credited to the Erhard accounting with respect to the $1,000,000 collateral deposit. Werner Erhard paid the interest on the Barclays Kol loan with bonus payments he received from Associated Advisors.

In May and June 1981 , WEA and est, a.e.c. entered into a series of agreements with respect to the acquisition by WEA of certain operating assets from est, a.e.c. These agreements involve the lease/purchase of assets at fair market values to be determined by independent appraisals. Additional agreements were also reached for the purchase by WEA of art works, an auxiliary sloop (the Sirona), the Body of Knowledge and certain quitclaims relating to the Body of Knowledge from Associated Advisors, PMSA and the Werner Erhard Charitable Settlement.

In implementing the documentation for the asset transfer in mid-1981 from est, a.e.c. to WEA, Margolis deemed it appropriate for Schreiber to make final decisions for est, a.e.c. as well as for WEA as to the documentation to be utilized. In a memorandum to Pat Dillan and William Gifford dated August 1, 1981, Margolis indicated that some $2,000,000 in assets involved in the asset transfer were handled without his involvement. Margolis also stated in the August 1, 1981, memorandum that he had no confidence in the appraisals used in connection with the asset transfer.

By agreements dated May 15, 1981, est, a.e.c. leased to WEA certain personal property and leasehold improvements at locations throughout the United States and granted WEA an option to purchase the personal property leases and leasehold improvements. By agreement dated July 31, 1981, WEA exercised its option to purchase the personal property and leasehold improvements from est, a.e.c. On August 24, 1981, WEA paid $1,610,370.80 pursuant to this agreement.

On May 15, 1981, est, a.e.c. and WEA executed some 32 agreements for the sale of existing real estate leases in various states by est, a.e.c. to WEA at stated valuations. On July 31, 1981, WEA agreed to pay an additional $1,465,318 to est, a.e.c. for the 32 leaseholds in order to reflect the valuation subsequently determined for such leaseholds by an independent appraisal. By checks dated May 27, 1981, WEA paid $1,143,932 to est, a.e.c. for the acquisition of the 32 leases subject to adjustment upon receipt of independent appraisals at fair market values. On August 24, 1981, pursuant to the subsequent appraisals, WEA paid an additional $1,465,318 to est, a.e.c.

On June 1, 1981, est, a.e.c. and WEA executed an agreement for the sale of graduate records from est, a.e.c. to WEA for the amount of $750,000. WEA also agreed to pay est, a.e.c. $250,000 for an agreement not to compete. The June 1, 1981, agreement also stated the following:

> The parties recognize that est may have accumulated certain rights with regard to certain programs owned by Werner Erhard and unrelated to the est Body of Knowledge. Such programs and materials related thereto were in part developed by est employees working under the general supervision of Werner Erhard, and such programs were marketed and promoted by est for its own account.

> The parties desire to set at rest any question concerning ownership, the right to use, prior assignments, and all aspects of everything including materials related to such programs, which include the Communication Workshop, 6-day Training, 7-day training, assisting program, courses on Well-Being, consulting, relationships and all material offered on audiotapes. This agreement shall operate as an assignment and quitclaim pursuant to which all of the rights of est are hereby assigned and set over to WEA effective the 1st day of June, 1981, without reservations of any kind. est will join in the defense of any claims against such material asserted by anyone provided only that such activity shall be paid for by WEA. Any document required by WEA at anytime or for any purpose to carry out the intention of the parties to vest ownership of everything in WEA shall be executed by est provided only that any cost connected therewith shall be paid for by WEA. In specific consideration of this assignment and transfer of all est's interest, WEA has paid est the sum of $100,000.

On July 31, 1981, est, a.e.c. and WEA agreed to an adjustment in the sales price previously reached for the graduate records in order to reflect the valuation of the property subsequently determined by an independent appraisal.

On June 1, 1981, est, a.e.c. and WEA executed an agreement for the sale of miscellaneous items, including certain motor vehicles by est, a.e.c. to WEA. On July 31, 1981, est, a.e.c. and WEA agreed to an adjustment in the sales price previously determined for the motor vehicles and WEA agreed to pay an additional $36,900 to est, a.e.c. in order to reflect the valaution of such motor vehicles subsequently determined by an independent appraisal.

On July 31, 1981, est, a.e.c. and WEA agreed to an adjustment in the sales price previously determined for the graduate records and est, a.e.c. agreed to pay $371,200 to WEA to reflect the valuation of the graduate records subsequently determined by an independent appraisal.

An agreement between est, a.e.c. and WEA dated July 31, 1981, in which WEA agreed to exercise an option to purchase real property (the Franklin House in San Francisco) was made effective as of July 1, 1981. An agreement between est, a.e.c. and WEA dated July 31, 1981, in which WEA agreed to exercise an option to purchase certain personal property located in various cities was made effective as of July 1, 1981. An agreement between est, a.e.c. and WEA dated July 31, 1981, in which WEA agreed to exercise an option to purchase certain computer hardware and software was made effective as of July 1, 1981.

On May 29, 1981, WEA authorized payment to PMSA for the materials collectively called the Body of Knowledge. On June 2, 1981, PMSA executed a quitclaim document in favor of WEA with respect to the Body of Knowledge. On May 27, 1981, WEA issued a check to est, a.e.c. in the amount of $150,000 in payment for the Body of Knowledge material. On June 1, 1981, est, a.e.c. executed a bill of sale and quitclaim in favor of WEA for the Body of Knowledge material.

In a letter to Margolis dated August 5, 1981, Alexia acknowledged receipt of a memorandum from Margolis dated July 17, 1981, together with a copy of an agreement of sale of certain art works by the Werner Erhard Charitable Settlement, to WEA. The August 5, 1981, letter also referred to an enclosed executed copy of the agreement of sale. The sales agreement for the art work recited that it was entered into on June 1, 1981.

In the course of the transfer of the assets of est, a.e.c. to WEA in mid-1981, Gifford had regular and frequent dealing with Margolis. Gifford agreed to the request of Margolis that the officers of est, a.e.c. who had become officers of WEA would stay on as officers of est, a.e.c. as the nominees of Margolis in the implementation of the various agreements between est, a.e.c. and WEA.

The role of Margolis as the source of the funds required in the asset acquisition transaction was recognized by Werner Erhard as well as his agents and his legal representative in the various stages leading up to the September 1981 asset transfer transaction. Margolis proposed a variety of alternatives to Werner Erhard and his legal counsel for the routing of the cash flow to effectuate the asset acquisition by WEA. Margolis agreed to arrange short-term interim financing for WEA for 60 to 90 days at market interest rates. Margolis arranged a loan from Barclay Bank of San Francisco to WEA. On or about May 29, 1981, WEA borrowed $5,000,000 from Barclays Bank of San Francisco for a period of 90 days at 19-7/8 percent interest. WEA gave the bank a promissory note and general security interest for the loan. Parallax Corp. provided a guarantee for the loan of $5,000,000 made by Barclays Bank of San Francisco to WEA. On June 1, 1981, WEA also obtained short-term financing of $2,200,000 from Terla, B.V., on an open account loan at 20 percent interest.

By agreement dated June 1, 1981, WEA agreed to purchase from est, a.e.c. certain miscellaneous items, including motor vehicles, for $20,000. By agreement dated July 31, 1981 WEA agreed to pay to est, a.e.c. an additional $36,900 for the motor vehicles based upon an independent appraisal. On December 31, 1981, WEA paid to est, a.e.c. the amount of $347,815 representing a part of the improvements to a certain property referred to as Mountain Lake Manor; $329,145 for security

and rental deposits on leased offices; and an additional $730,473 for other miscellaneous items acquired from est, a.e.c. including prepaid accounts for insurance, taxes, notes receivable, employee advances and wine inventory.

On June 1, 1981, est, a.e.c. agreed to lease the Franklin House to WEA with an option to purchase. On July 31, 1981, WEA exercised its option to purchase the Franklin House from est, a.e.c. for $725,000 based on the valuation of an independent appraiser. On June 1, 1981, est, a.e.c. leased to WEA certain computer equipment and software with an option to purchase. On July 31, 1981, WEA exercised its option to purchase the computer equipment and software for $272,470 based on the valuation of an independent appraiser. Pursuant to an agreement dated June 1, 1981, WEA made the following payments to est, a.e.c.: (1) $750,000 for graduate records; (2) $250,000 pursuant to a non-competition clause; (3) $100,000 for certain residual rights; and (4) $10,000 for goodwill. On July 31, 1981, WEA and est, a.e.c. agreed to readjust the purchase price for the graduate records to reflect an independent appraisal of the value of such records. On August 27, 1981, est, a.e.c. repaid $371,200 to WEA representing the reduction in the purchase price of the graduate records.

On June 22, 1981, est, a.e.c. agreed to assign to WEA its rights in a contract for land and building in Royal Oak, Michigan. On December 22, 1981, WEA paid est, a.e.c. $140,212.60 for the land contract plus interest. By agreement dated June 1, 1981, the Werner Erhard Charitable Settlement agreed to sell to WEA certain works of art for $865,038. WEA paid this amount in full by July 22, 19 81. Pursuant to an agreement executed June 2, 1981, WEA paid $50,000 to PMSA for a quitclaim to any right, title and interest held by PMSA in the Body of Knowledge. By agreement dated June 1, 1981, WEA paid $150,000 to est, a.e.c. for a quitclaim to any right,

title and interest held by est, a.e.c. as licensee in the Body of Knowledge. By agreement dated July 1, 1981, WEA paid $1,385,000 to Welbehagen, B.V., for its right, title and interest in the Body of Knowledge. By agreement dated June 1, 1981, WEA, paid $50,000 to est of India for its right, title, and interest in the Body of Knowledge. By agreement dated June 1, 1981, WEA, in return for a payment of $20,000.00 and a credit of $30,000 against future WEA billings, acquired from est of England its right, title and interest in the Body of Knowledge. By agreement dated June 1, 1981, WEA, in return for the allowance of a $50,000 credit against future WEA billings, acquired from est of Canada its right, title and interest in the Body of Knowledge.

By agreement dated May 15, 1981, Associated Advisors leased the auxiliary sloop Sirona to WEA with an option to purchase. By agreement dated July 1, 1981, WEA exercised its option to purchase the Sirona for the appraised value of $225,000. The Sirona had been used by Werner Erhard for business and pleasure while he was an employee of est, a.e.c.

On June 1, 1981, WEA paid $1,062,847.22 to Barclays Kol in payment of the principle and interest on an outstanding loan to Werner and Ellen Erhard. On June 1, 1981, Werner and Ellen Erhard entered into an accord and satisfaction agreement with Associated Advisors upon payment of $250,000 to Associated Advisors in satisfaction of all notes and obligations of Werner and Ellen Erhard, including a mortgage on their residence. On August 24, 1981, WEA purchased for $94,449 certain loans from Antigua Banking, Ltd., to third parties who were to become employees of WEA. On June 26, 1981, WEA paid $215,000 to Werner Erhard, and on the same date Werner Erhard made a contribution in the same amount to an entity called Breakthrough Foundation.

The total loan proceeds of $7,200,000 obtained from Barclays Bank of San Francisco and Terla, B.V., were used by WEA as follows: (1) $2,249,323 retained by WEA as working capital; (2) $2,706,792 paid to est, a.e.c. for real estate leases ($1,143,932), personal property in the leased offices ($199,360), a deposit on the Franklin House building ($50,000), a deposit on computer hardware and software ($33,500), graduate records ($750,000), a non-competition agreement ($250,000), a quitclaim of rights in the Body of Knowledge ($150,000), a quitclaim of rights in separate property ($100,000), goodwill ($10,000) and motor vehicles ($20,000); (3) $865,000 paid to Alexia for art works; (4) $50,000 paid to PMSA for a quitclaim of rights in the Body of Knowledge; (5) $1,062,847 paid to Barclays Kol to repay the principal and interest on a loan to Werner Erhard and Ellen Erhard; (6) $16,000 paid to Associated Advisors as a deposit on the auxiliary sloop Sirona; and (7) $250,000 paid to Associated Advisors as a loan repayment.

As of June 1, 1981, WEA took over all of the business operations formally conducted by est, a.e.c., including the seminars, the 6-day training and the est standard training. Substantially all the employees of est, a.e.c. became employees of WEA. Generally, Werner Erhard continued the same basic work in the operations of WEA that he had performed prior to June 1, 1981, with est, a.e.c.

In a June 19, 1981, memorandum from Gary Grace to Margolis, Gary Grace forwarded a list of outstanding loans to Werner Erhard from Antigua Banking, Ltd. The series of loans over a period from about September 20, 1980, through about May 8, 1981, were in a total amount of $308,500. The memorandum referred to a request from Werner Erhard to have the outstanding loans repaid through WEA by increasing the ultimate loan to WEA by a like amount.

During the clean-up phase of est, a.e.c. in 1980 and 1981, Margolis advised against the preparation of documents that could jeopardize the defense of past tax planning. At the conclusion of the clean-up phase in 1981, est, a.e.c. was left in the control of Margolis and his system entities. In an agreement effective as of June 1, 1981, Am-Pro obtained an option to acquire from Alexia all of the stock of est, a.e.c. In August 1981, Am-Pro notified Alexia of its decision not to acquire the est, a.e.c. stock pursuant to the option agreement.

Wolfgang Somary is a banker in Switzerland. He is a member of the board of the EBC (European Banking Company) Switzerland Ltd., Corp., and is also a partner and director of STA Salmann Trust of Valduz, an asset management company. Upon his father's death, Somary took over his father's private bank, Blankart & Company. Somary merged Blankart & Company into a larger Swiss private bank, Bank Sarasin, where he was a managing director and limited partner until 1985. Somary was also a co-founder in 1974 of ICF, a tax-exempt organization under Swiss law. The purpose of the foundation was to pave the way to new forms of thinking and education and to engage in cross-cultural research. ICF is required to file annual reports with the Swiss Federal Ministry of the Interior. The books and records of ICF are audited on an annual basis by a Swiss accounting firm.

In April 1981, Werner Erhard telephoned Somary to explain the formation of WEA and also to inform Somary of the need for a loan of about $9,000,000 - $10,000,000. Somary was unable to provide the funds. Shortly thereafter, Somary was called by Margolis who inquired whether Erhard had contacted Somary about the need for financing and whether ICF would be willing to accept funds made available by an entity designated by Margolis and to then lend such funds to the Werner Erhard organization. In May 1981 Somary notified

Erhard that he would be willing to finance a loan to WEA pending further arrangements. Margolis subsequently notified Somary that he had located a source of funds in the amount of $14,000,000.

Fernando Flores is a retired Costa Rican diplomat and the Legate for the Americans of the Sovereign Order of the Hospital of St. John of Jerusalem in Denmark. In 1981 Flores was co-founder of St. John Fundacion, a non-profit foundation for humanitarian, educational, charitable and social purposes. Werner Erhard contacted Flores to explain the need for the financing of the asset acquisition by WEA. Subsequently, Margolis contacted Flores to inquire whether he had been contacted by Werner Erhard and whether he would be willing to make a loan to Erhard if such funds were available. Flores expressed his willingness to do so. Margolis wanted both ICF and St. John Fundacion to participate in the loan to Erhard. The loan to Erhard which was eventually made was in the amount of $14,000,000. Gifford regarded a fully disclosable source of the $14,000,000 to Erhard as essential to an acceptable asset acquisition plan.

In a memorandum dated July 31, 1981, Erhard was informed by Gifford that on July 18, 1981, Margolis had indicated that, with respect to the source of funds needed for the asset acquisition by WEA, "The truth is that there is no source other than the accumulated values of the past decade."

On September 9, 1981, Erhard requested that an account be opened for him designated as d/b/a WEA at FNBBP with an initial deposit of $500. On July 12, 1982, this account at FNBBP (indicating a balance of $500) was closed.

On September 10, 1981, Wolfgang F. Somary requested that an account be opened for ICF at FNBBP with an initial deposit of $500. On September 15, 1981 Everd B. van Walsum

requested that a personal account be opened for him at FNBBP. Everd B. van Walsum informed Fernando Flores while in Panama that he would represent ICF in the September 1981 banking transactions involving the transaction which did not pass through his account at FNBBP but, instead, went through the account opened at FNBBP by van Walsum. On September 15, 1981, Mason requested that a personal account be opened at FNBBP designated as Mason for St. John Fundacion. The account was closed in 1985 when donations from ICF ceased.

By letter dated September 9, 1981 to FNBBP, WEA instructed FNBBP that upon receipt from ICF on or about September 15, 1981, of funds in the amount of $14,000,000, to immediately transfer such funds to an account opened by WEA at Island Bank, Ltd. The September 9, 1981, letter to FNBBP was signed by Werner Erhard. By letter to Island Bank, Ltd., dated September 9, 1981, WEA instructed Island Bank, Ltd., that immediately upon deposit in the WEA account of $14,000,000, Island Bank, Ltd., was instructed to pay to Barclays Bank of San Francisco the $5,000,000 loan due from WEA and to pay the balance of $9,000,000 to Erik Holding, B.V. The September 9, 1981, letter to Island Bank, Ltd., was signed by Werner Erhard. The September 9, 1981, letter from WEA to FNBBP was drafted on the basis of information provided by the office of Harry Margolis.

On September 10, 1981, ICF and BEC executed an Agreement and Instructions, which had been drafted by Margolis, with respect to the processing of the contemplated $14,000,000 loan:

> This agreement is executed by Wolfgang F. Somary, acting as director of the Intercultural Cooperation Foundation, established under the laws of Switzerland, hereinafter referred to as the Foundation,

and Brown Educational Corporation, an Oklahoma corporation, hereinafter referred to as BEC.

Witnesseth

Whereas BEC intends to make fourteen million dollars ($14,000,000.00 U.S.) available to Foundation, and whereas Foundation wishes specific instructions with regard to such funds,

now, therefore, in consideration of the premises, it is hereby agreed:

1.) The fourteen million dollars ($14,000,000.00 U.S. Dollars) which is the subject of this agreement will be made available to Foundation at the First National Bank of Boston, Panama City, Panama, by deposit by BEC to the account of Foundation.

2.) Foundation is instructed to transfer such fourteen million dollars ($14,000,000 U.S.) to the account of the Fundacion Soberana Orden de San Juan de Jerusalem in Costa Rica, a charitable entity organized under the laws of Costa Rica, hereinafter referred to as St. John, at the First National Bank of Boston in the same branch.

3.) Foundation is instructed to obtain a note from St. John in a form satisfactory to Foundation. Foundation shall not be responsible for the genuineness of the signatures on such note, nor for the failure of St. John to deliver. * * *

4.) Foundation shall retain possession of such note. Foundation shall endorse and deliver such note to BEC at any time that the note may be in default, provided that BEC shall give Foundation ninety (90) days' written notice requesting the endorsement and

delivery of such note and provided further that such default shall continue through the entire 90 day notice period. Upon delivery of such endorsed note. Foundation shall have no further obligation hereunder other than to assist BEC in any reasonable request related to the total situation. Provided only that all expenses in connection with any such request shall be paid for by BEC. The note shall be endorsed without recourse when as and if delivered by Foundation to BEC.

5.) No assignment of this agreement shall be made by either party without the express prior written consent of the other.

6.) All proceeds of the note, exclusive only of the principal, shall be the property of Foundation and BEC shall make no claim thereto. Any portion of principal received by Foundation at any time shall be immediately transferred to BEC.

On September 10, 1981, ICF and St. John Fundacion executed an Agreement and Instructions, which had been drafted by Margolis together with Somary and Flores, with respect the processing of the contemplated $14,000,000.00 loan:

This document is executed by the International Cooperation Foundation of Zurich, Switzerland, hereinafter referred to as Foundation, and the Fundacion Soberana Orden de San Juan de Jerusalem of Costa Rica, hereinafter referred to as San Juan.

Witnesseth:

Whereas Foundation intends to deposit Fourteen Million Dollars ($14,000,000 U.S.) to the account of San Juan, and whereas San Juan requests instruc-

tions with reference to the disposition of said sum: now, therefore, in consideration of the premises, it is hereby agreed:

1.) Foundation will deposit fourteen million dollars ($14,000,000) to the account of San Juan at the First National Bank of Boston, Panama City, Panama, on September 15, 1981.

2.) Said sum is intended to constitute a restricted loan and grant by Foundation to San Juan, as herein set forth.

3.) The parties share goals and aspirations in a broad range of human affairs. They intend that the fourteen million dollars ($14,000,000 US) shall be made available to Werner Erhard, doing business as Werner Erhard and Associates, for a period of ten (10) years. A form of non-negotiable promissory note has been provided by Foundation to San Juan. Such note shall be executed by Werner Erhard and Associates when San Juan delivers the fourteen million dollars ($14,000,000 US) to Werner Erhard. Immediately thereafter San Juan shall endorse and deliver such note to Foundation. Such endorsement may be without recourse.

4.) The annual interest payable of $280,000 (two hundred eighty thousand U.S. Dollars) shall be utilized execlusively for charitable and educational purposes. The parties understand that the holder of the note will have sole legal discretion with reference to the selection of the projects to be funded. Initially, Foundation contemplates utilizing twentyfive thousand dollars ($25,000 US) for the direct purposes of the Foundation. Foundation contemplates

that thirty thousand dollars ($30,000 US) shall be made available to the Order of St. John of Jerusalem in Denmark. With reference to the balance, Foundation contemplates distribution to San Juan for work in Central America in the areas of peace, hunger, education and public health.

5.) No assignment of any portion of this Agreement may be made without the express prior written approval of both parties.

By letter to FNBBP dated September 9, 1981, Erhard advised the bank that a $14,000,000 deposit was expected to be made to his account on September 15, 1981, and directed the bank to transfer that amount to Island Bank, Ltd., for the account of WEA. By letter dated September 9, 1981, to Mason, managing director of Island Bank, Ltd., Erhard instructed Island Bank, Ltd., to transfer the $14,000,000 as follows: $8,976,284.95 to Erik Holding B.V., and $5,035,972.34 to Barclays Banks of San Francisco. The reference in the letter to Erik Holding, B.V., was a mistake; the transfer of $8,976,284.95 was to be made to Terla, B.V. Erhard closed the account of WEA at FNBBP in July 1982.

By letter dated September 5, 1981, to FNBBP, St. John Fundacion requested the opening of a bank account in its name and made an initial deposit of $500. On the recommendation of Margolis, Flores (St. John Fundacion) authorized Mason to bank at FNBBP as an agent for St. John Fundacion. On September 15, 1981, Mason provided FNBBP with an authorization letter from ICF to transfer $14,000,000 to St. John Fundacion and a letter of instructions from St. John Fundacion rquesting the transfer of the $14,000,000 to the account of WEA at the bank.

On September 15, 1981, ICF, through St. John Fundacion, made a loan of $14,000,000 to Werner Erhard and his sole

proprietorship. On September 15, 1981, Werner Erhard individually and for WEA executed a non-negotiable note in the amount of $14,000,000 due and payable to St. John Fundacion on August 31, 1991, at Barclays Bank of San Francisco. The note specified interest of two percent per annum. The note stated that St. John Fundacion intended to endorse the instrument to ICF, and said endorsement to ICF was accordingly made by St. John Fundacion effective September 15, 1981. The note provided as security substantially all of the assets of WEA, as well as the proceeds from any disposition thereof. The security, however, was subordinated to any indebtedness of WEA incurred in its business and any security interest related thereto. The proceeds of the $14,000,000 loan from ICF on September 15, 1981, were used to repay the short-term financing from Barclay Bank of San Francisco and Terla, B.V. Upon the suggestion of Margolis, Somary issued instructions for the delivery of the $14,000,000 note to Island Bank, Ltd., for safekeeping. Everd van Walsum acted as trustee on behalf of ICF in the banking transactions that took place on September 15, 1981. The role of St. John Fundacion was to receive a conditional grant loan of $14,000,000 from ICF and, in turn, to loan this amount to WEA. Flores did nothing to insure that the $14,000,000 loan would be repaid by Werner Erhard. Flores understood that it was the responsibility of ICF to insure repayment of the note in view of the endorsement by Flores of the note back to ICF. After Somary and Margolis discussed the opening of a bank account for ICF at FNBBP, Somary suggested to Flores that the pending banking transaction involving the money tranfer should take place at FNBBP rather than in Costa Rica. Margolis recommended Mason to Flores as one who could assist Flores in the banking transaction at FNBBP. Mason did in fact act on behalf of St. John Fundacion at FNBBP.

The Werner Erhard promissory note in the amount of $14,000,000 was secured by the assets of Erhard. However,

the note instruments removes the Franklin House in San Francisco as security and also subordinated the loan to the obligations which might arise in the ordinary course of business. The value of the security for the note obligation was indeterminable. Under Swiss law, the collateral provisions in the note instrument were enforceable only with respect to assets located in Switzerland. In 1984, Somary allowed WEA to substitute other collateral for the graduate list in the event of any default on the promissory note. At the time ICF made the loan of $14,000,000, Somary knew that a balance sheet for WEA as of August 31, 1981, showed a negative net worth. On September 15, 1981, van Walsum provided documentation to FNBBP to open a trustee account designating van Walsum to act for ICF. This account was then credited with $14,000,000 on September 15, 1981, from BEC.

On September 15, 1981, FNBBP notified Erhard that $14,000,000 had been debited from his account and credited to the account of Island Bank, Ltd., at FNBBP per Erhard's instructions. By letter dated September 15, 1981, Erhard received confirmation of the transfer from the account of Island Bank, Ltd., of $8,976,284.95 to Terla, B.V. On September 15, 1981, $5,023,500 was credited to the WEA account at Barclays Bank of San Francisco. WEA then paid $5,035,972.23 to Barclays Bank of San Francisco. WEA paid ICF the required interest payments on the $14,000,000 note and withheld the statutory 5 percent withheld tax on such payments made to foreign persons.

ICF obtained the $14,000,000 from BEC an entity which had been formed in or about September 1981 as part of the tax planning of Margolis and Reiserer. A condition to ICF's agreement to receive funds from BEC was that ICF would not be liable to BEC in the event WEA defaulted on the loan. BEC obtained the $14,000,000 which it loaned to ICF from Sineuri, S.A., a Panamanian company.

In 1981, BEC had cash assets in the amount of $1,000. Although Beadle was an officer and director of BEC, the transfer of $14,000,000 in September 1981 to ICF was not discussed with him and he was not aware of such transfer. Generally, Singleton and Reiserer conducted the BEC board of directors meetings in 1981 and presented documents to the board of directors for their signatures. In 1981 BEC received $15,000,000 from Sineuri, S.A., and, at the request of Margolis, BEC transferred $14,000,000 to ICF. Margolis was responsible for the arrangements between BEC and ICF with respect to the $14,000,000 transfer. Johnny Brown executed the documents relating to the transfer of $14,000,000 to ICF pursuant to instructions from Reiserer. BEC subsequently assigned to Island Bank, Ltd., all right, title and interest in the $14,000,000 promissory note from ICF.

As of September 14, 1981, the balance in the Island Bank, Ltd., account at Barclays Bank of San Francisco was $40,088.42. On September 15, 1981, Island Bank, Ltd., deposited $125,804,000 in its account at Barclays Bank of San Francisco. This was accomplished through a series of transfers. The sources of the deposits into the Island Bank, Ltd., account at Barclays Bank of San Francisco were transfers from Barclays Bank of San Francisco and various partnerships formed by Margolis and used by him in his tax planning. On September 15, 1981, Island Bank, Ltd., transferred $125,803,410 out of its account at Barclays Bank of San Francisco. The transfer of said amount on September 15, 1981, was made by Island Bank, Ltd., to Barclay Bank of San Francisco and to the account of Island Bank, Ltd., at FNBBP. The balance in the Island Bank, Ltd., account at Barclays Bank of San Francisco as of September 15, 1981, was $40,738.42.

On September 15, 1981, Island Bank, Ltd., transferred $96,000,000 from its account at FNBBP to the account of

Sineuri, S.A., at FNBBP. On the same date, Sineuri, S.A., transferred $15,000,000 from its account at FNBBP to the account of BEC at FNBBP. On September 15, 1981, BEC transferred $14,000,000 from its account at FNBBP to ICF through an account in the name of Everd van Walsum at FNBBP. On September 15, 1981, BEC transferred $1,000,000 from its account at FNBBP to the account of Island Bank, Ltd., at FNBBP. On September 15, 1981, ICF transferred $14,000,000 from its account at FNBBP to St. John Fundacion through an account at FNBBP in the name of Paul Mason. On September 15, 1981, St. John Fundacion transferred $14,000,000 from its account at FNBBP to the account of Werner Erhard & Associates at FNBBP. On September 15, 1981, WEA transferred $14,000,000 from its account at FNBBP to the account of Island Bank, Ltd., at FNBBP. On September 15, 1981, Island Bank, Ltd., transferred $8,976,284.95 from its account at FNBBP to the account of Terla, B.V., at FNBBP. On September 15, 1981, Island Bank, Ltd., transferred $5,023,500 from its account at FNBBP to WEA account at Barclays Bank of San Francisco. On September 15, 1981, WEA transferred $5,035,972.23 from its account at Barclays Bank of San Francisco to Barclays Bank of San Francisco.

The bank balance of Island Bank, Ltd., in its account at First National Bank of Boston, Panama (hereinafter FNBBP) on September 14, 1981, was $1,728.06. On September 15, 1981, Island Bank, Ltd., made net deposits of $297,703,500 into its account at FNBBP. On said date, a series of transfers were made back and forth between various entities and Island Banks, Ltd. The series of transfers back and forth with a particular entity, such as Terla, B.V., and Island Bank, Ltd., on September 15, 1981, have been netted in reaching the net deposits total in Island Bank's account at FNBBP on September 15, 1981. The sources of the net deposits into

Island Bank's account at FNBBP on September 15, 1981, were transfers from Terla, B.V, Island Bank's account at Barclays Bank of San Francisco, WEA's account at FNBBP, and BEC. On September 15, 1981, Island Bank, Ltd., transferred $297,703,500 in net payments out of its account in FNBBP. Again, these transfers were accomplished through a series of payments. These net payments out of Island Bank's account at FNBBP on September 15, 1981, were made to WEA's account at Barclays Bank of San Francisco, Parallax Corp., Mundial Investment, Mator, S.A., Antigua Banking, Ltd., and Sineuri, S.A. On September 16, 1981, the balance in the Island Bank, Ltd., account at FNBBP was $1,725,56.

On June 26, 1981, Werner Erhard received a check from WEA in the amount of $215,000. On June 26, 1981, Werner Erhard sent a check in the amount of $215,000 to the Breakthrough Foundation. Breakthrough Foundation then transferred $213,519.29 to the account of Kempold, B.V., at Island Bank, Ltd. On August 31, 1981, WEA transferred $251,197.22 to Barclays Bank of San Francisco. On December 21, 1981, WEA transferred $1,547,645 to est, a.e.c.

On September 15, 1981, Antigua Banking, Ltd., transferred $1,036,000 to WEA. On September 15, 1981, WEA transferred $1,000,000 to Antigua Banking, Ltd.,

The repayment by WEA of the outstanding $5,000,000 loan from Barclays Bank of San Francisco was a prerequisite to the release of the $14,000,000 loan to WEA. Margolis arranged with Antigua Banking, Ltd., for a one-day loan to WEA of $1,036,000 to enable WEA to repay its loan to Barclays Bank of San Francisco on September 15, 1981.

On August 27, 1981, Antigua Banking, Ltd., made transfers of $50,000, $600,000 and $105,575.35 to the Harry E. Wright, Jr., Charitable Trust. On August, 27, 1981, the Harry E. Wright, Jr., Charitable Trust transferred $750,000 to the

account of Island Bank, Ltd. On September 15, 1981, Antigua Banking, Ltd., transferred $40,000 to the Harry E. Wright, Jr., Charitable Trust. On December 17, 1981, Antigua Banking, Ltd., transferred $250,000 to the Harry E. Wright, Jr. Charitable Trust. On December 17, 1981, the Harry E. Wright, Jr., Charitable Trust transferred $250,000 to the account of Island Bank, Ltd., at FNBBP. On December 18, 1981, Island Bank, Ltd., transferred $1,000,000 to ICF. The "check request" document relating to this transfer identified the transaction as a transfer of funds for the Harry E. Wright, Jr., Charitable Trust. On December 22, 1981, ICF transferred $1,000,000 to St. John Fundacion and on the same date St. John Fundacion transferred $1,000,000 to WEA.

On August 27, 1981, WEA borrowed from Terla, B.V., an additional $6,580,000 on open account loans of $2,300,000, $3,500,000 and $780,000 at 20 percent interest. The amount borrowed from Terla, B.V., was used by WEA as follows: (1) $850,854 was retained by WEA as working capital; (2) $3,693,868 was paid to est, a.e.c. as adjustments to the purchase prices of various assets to conform to appraised values determined by independent appraisers; (3) $1,385,000 was paid to Welbehagen, B.V., for the purchase of the Body of Knowledge; (4) $342,829 was paid to Antigua Banking, Ltd., to repay a loan; (5) $94,449 was paid to Antigua Banking, Ltd., to purchase outstanding loans to third parties; and (6) $213,000 was paid as the balance of the purchase price of the Sirona. Margolis coordinated the transfer of $14,000,000 from BEC to ICF to St. John Fundacion. Margolis also instructed Somary with respect to the required agreements and transfers of funds from BEC to ICF and also on the required agreements and transfers of funds from ICF to St. John Fundacion, including the banking instructions that should be issued, the opening of the ICF account at FNBBP, and the fact that St. John Fundacion would be used as a conduit of funds between ICF and

WEA. Margolis provided Somary with a draft letter to FNBBP to authorize van Walsum to act on behalf of ICF in the September 15, 1981, banking transactions involving the $14,000,000 loan.

In or about October 1981, Erhard requested additional funds from Somary, but ICF did not have the resources to enable Somary to comply. Margolis located the additional funds in the amount of $1,000,000 from a purported client, the Harry E. Wright, Jr., Charitable Trust. In arranging the loan in December 1981 of $1,000,000 to WEA, Margolis, together with Somary and Flores, planned to follow the same procedures that were used with respect to the $14,000,000 loan to WEA in September 1981.

Margolis was counsel, financial advisor and accountant to the Harry E. Wright, Jr., Charitable Trust. In 1981, Thorne, representing the Trust, agreed to distribute $1,000,000 to ICF even though he did not have this amount. Margolis arranged the transaction. ICF thereafter funded a $1,000,000 loan to WEA. Thorne did not know that the amount of $1,000,000 transferred to ICF was subsequently loaned by ICF to WEA.

The Harry E. Wright, Jr., Charitable Trust received the following amounts from Antigua Banking, Ltd.: $50,000 on August 27, 1981; $40,000 on September 15, 1981; and $250,000 on December 17, 1981. Antigua Banking, Ltd., was used as a source of these loans at the suggestion of Margolis. On August 27, 1981, the Harry E. Wright, Jr., Charitable Trust transferred $750,000 to Island Bank, Ltd. On December 17, 1981, the Harry E. Wright, Jr., Charitable Trust transferred $250,000 to Island Bank, Ltd., through FNBBP.

Pursuant to agreement, the amount of $1,000,000 was transferred to ICF from the Harry Wright, Jr., Charitable Trust. On or about December 22, 1981, ICF made a restricted loan of $1,000,000 to St. John Fundacion, which in turn made a

loan of $1,000,000 to WEA. Werner Erhard, individually and for WEA, executed a non-negotiable note dated December 22, 1981, payable to St. John Fundacion in the amount of $1,000,000 payable on demand at two percent interest. St. John Fundacion endorsed the note to the order of ICF. On December 22, 1981, WEA paid $1,547,645 to est, a.e.c. consisting of the following items: (1) Part payment of improvements to Mountain Lake Manor, $347,815; (2) security and rental deposits on leased offices, $329,145; (3) contract for Detroit building, $140,212; and (4) miscellaneous other assets, $730,473.

The bank statements for the St. John Fundacion account at FNBBP for the period January 1981 to October 1985 were forwarded to Mator, S.A., in Panama until March 1983 and were subsequently forwarded to one Rocio Viluce, a former Mator, S.A. employee who left Mator, S.A., to establish a business management company.

WEA made the required interest payments to ICF on the $1,000,000 note and withheld the statutory withholding tax of 5 percent on such payments to foreign persons. In early 1985, WEA repaid the $1,000,000 loan with $550,000 of this amount transferred to Island Bank, Ltd., rather than to ICF, and ICF returned the $1,000,000 promissory note to WEA. Island Bank, Ltd., informed ICF that it would not release the $550,000 unless Somary initiated action in California to uphold the validity of the $14,000,000 note. In 1985, repayment of the $14,000,000 by WEA was questionable because of developments in the pending matrimonial action between Ellen Erhard and Werner Erhard. As of the time of the trial of this case, the amount of $550,000 has not been released by Island Bank, Ltd., to ICF. ICF expended some $400,000 out of the payments made by WEA as interest for legal expenses and miscellaneous expenses related to proceedings undertaken by

ICF with respect to the validity of the notes in the matrimonial action involving Werner and Ellen Erhard.

In August and September 1981, Margolis and Schreiber exchanged memoranda which discussed the treatment of numerous items of concern to Werner Erhard and WEA. A September 7, 1982, memorandum form Margolis to Schreiber concerning audit reports of WEA by certified public accountants enumerated a variety of items that required consideration.

In 1981, Werner Erhard personally had a negative net worth. Erhard and his associates did not have available funds to acquire the est, a.e.c. assets in 1981. Since WEA had a balance sheet with assets of less then $1,000,000 and would be unable to obtain bank financing, Schreiber requested Margolis to arrange certain short-term financing for the asset acquisition until long-term financing could be arranged. In mid-1983, Werner Erhard filed a personal financial statement with Barclays Bank of San Francisco to obtain a continuing guarantee for WEA in the amount of $450,000 in which he did not list the loans of $14,000,000 and $1,000,000 as liabilities. In 1983, WEA established a bookkeeping account for a sinking fund to repay the combined loan of $15,000,000. During the course of the matrimonial action in 1985 between Ellen Erhard and Werner Erhard, substantially all of the funds were withdrawn from the sinking fund pursuant to the direction of the California Supreme Court. Deposits of funds in the sinking fund were subsequently discontinued. The amounts earmarked for the sinking fund were placed in certificates of deposit in the name of WEA.

Gilbert T. Schwartz, an attorney testified as petitioner's expert witness on the subject of banking law and practice and submitted a report. He reviewed the documentary materials pertinent to the $14,000,000 promissory note from Werner Erhard to St. John Fundacion and stated that in his opinion

the note was bona fide under customary and ordinary banking practices in the United States. His opinion was based on the form of the note and the underlying documentation generated by the various entities involved in the fund transfers. Schwartz was not an expert in the banking practice of Panama, Costa Rica or Switzerland. In his analysis of the bona fide nature of the $14,000,000 note, Schwartz did not consider the existence of business purpose, economic substance or the availability of any personal or contractural defenses against the note obligation.

A source and application of funds were subsequently prepared by Anthony V. Langone, petitioner's expert witness, of the cash receipts and disbursements of Erhard Seminars Training and est, a.e.c. over the years of their business operations. His conclusions were presented in his expert witness report.

Robert Feinerman, a retired presiding justice of the California Court of Appeals, testified as petitioner's expert witness on the enforceability of the $14,000,000 note and a $1,000,000 note executed by Erhard and on the lending practices of financial institutions. Feinerman examined the notes and other relevant materials and concluded that under California law the $14,000,000 was enforceable against Werner Erhard personally. Feinerman stated that the $14,000,000 note was subject to the provisions of Article 3 of the Uniform Commercial Code (UCC) adopted by California and that under the UCC, in the event of default by Erhard and WEA, ICF had the right to obtain judgment against Erhard on the note and enforce said judgment against the assets of Erhard.

Peter Hafter is a partner in a law firm in Zurich, Switzerland. He is also a director of the Swiss subsidiaries of Morgan Guaranty Bank and of the Swiss Bank in the Rothschild group. It was his opinion that pursuant to Swiss rules on conflicts of

law, the validity and enforceability of Erhard's obligations under the $14,000,000 note would be determined under California law. Hafter also concluded that the $14,000,000 note was enforceable under the laws of Switzerland.

On their returns for the taxable years 1981, 1982 and 1983, petitioners claimed depreciation deductions with respect to the property purchased by WEA from est, a.e.c., interest expense deductions relating to the short-term loans, and a prorate portion of the interest accrued on the long-term loan. est, a.e.c. reported the gains and losses from the sale of its assets to WEA on its Federal corporate income tax returns for the fiscal years ending June 30, 1981 and June 30, 1982.

On November 19, 1984, and December 3, 1985, respondent issued notices of deficiency to est, a.e.c. determining deficiencies for the respective fiscal years ending June 30, 1981, and 1982 in the respective amounts of $1,074,950 and $1,212,489 plus additions to tax and increased interest. est, a.e.c. filed petitions in the Tax Court for a redetermination of the deficiencies for each of the fiscal years involved. On October 7, 1988, the Tax Court granted respondent's Motion to Dismiss for Failure to Properly Prosecute the case involving the fiscal year ended June 30, 1981, (docket No. 3014-85). On January 9, 1989, the Tax Court granted respondent's Motion to Dismiss for Failure to Properly Prosecute the case involving the fiscal year ended June 20, 1982. (docket No. 4518-86).

In the statutory notice of deficiency issued to petitioners for the taxable year 1981 respondent made the following adjustment: (1) Disallowance of the Schedule C depreciation deduction in the amount of $884,024 in connection with the activity of the sole proprietorship Werner Erhard & Associates; and (2) disallowance of the Schedule C interest expense deduction in the amount of $227,951. In the statutory

notice of deficiency issued to petitioners for the taxable year 1982, respondent made the following adjustments: (1) Disallowance of the Schedule C depreciation deduction in the amount of $1,471,211 in connection with the activity of the sole proprietorship Werner Erhard & Associates; (2) disallowance of the Schedule C interest expense deduction in the amount of $300,000; and (3) disallowances of a Schedule A Charitable contribution carryover in the amount of $110,538. In the statutory notice of deficiency issued to petitioners for the taxable year 1983 respondent made the following adjustments: (1) Disallowance of the Schedule C depreciation deduction in the amount of $1,332,998 in connection with the activity of the sole proprietorship Werner Erhard & Associates; and (2) disallowance of the Schedule C interest expense deduction in the amount of $300,000.

OPINION

In June 1981, Werner Erhard, doing business as Werner Erhard & Associates (WEA), a sole proprietorship, acquired a variety of assets from est, a.e.c. and other entities. The acquisition of the assets was purportedly financed by short-term loans from Barclays Bank of San Francisco and Terla, B.V., (a Netherlands entity) which were refinanced in September 1981 by a $14,000,000 loan and a subsequent $1,000,000 loan from Intercultural Cooperation Foundation, a Swiss entity. WEA claimed depreciation expense deductions in the taxable years at issue with respect to the operating assets acquired from est, a.e.c. and also claimed interest expense deductions in the taxable years involved with respect to the purported short-term and long-term loans. Respondent disallowed both the depreciation expense deduction and the interest expense deductions on the grounds that (1) the transfer of assets should be disregarded because there was no real change in the ownership of the assets and that the

transaction lacked economic substance; (2) the $14,000,000 and $1,000,000 loan transactions were Margolis circular money movements which lacked economic substance; (3) the transaction was purely tax-motivated and lacked any business purpose; and (4) the 1981 transaction was merely the clean-up phase in the tax-planning structure previously installed by Harry Margolis for est, a.e.c.

Section 163(a) provides for the deduction of "all interest paid or accrued within the taxable year on indebtedness." In order to be deductible, interest must be paid on genuine indebtedness, an indebtedness in substance and not merely in form. *Knetsch v. United States,* 364 U.S. 361 (1960); *Karme v. Commissioner,* 73 T.C. 1163, 1185 (1980), aff'd. 673 F.2d 1062 (9th Cir. 1982). Section 167(a) allows a depreciation deduction for property used in a trade or business or held for the production of income. The depreciation deduction is computed on the adjusted basis of property, which generally is keyed to the cost of such property. Sections 167(g), 1011, and 1012. Cost is defined in the regulations as the amount paid for such property in cash or other property. Section 1.1012-1(a), Income Tax Regs. The application of these statutory provisions necessarily turns upon the realities of the particular transaction. Petitioners have the burden of proof. Rule 142(a).

Some background is necessary in order to provide a meaningful perspective to the 1981 transactions. See *Erhard Seminars Training v. Commissioner,* T.C. Memo. 1986-526; see also *est, An Educational Corporation v. Commissioner,* T.C. Memo. 1986-527. Since 1971, when Erhard commenced his operations centered around the dissemination of the so-called Body of Knowledge and other concepts originated by him, Harry Margolis has played a dominant role in the tax planning aspects of the Erhard operations. Until 1975, the

Erhard operation was conducted under the corporate form of Erhard Seminars Training, Inc., a California Corporation. Integral to the operations conducted during this period was the employment of the Margolis system which involved the tax-planning techniques of money movements among a congeries of system entities. The on-going financial status of a Margolis client vis-a-vis the system was reflected in the so-called system accounting. In 1975, est, a.e.c., a Nevada corporation, was formed to conduct the business activities previously conducted by Erhard Seminars Training, Inc., i.e., the presentation of the est standard training, seminars and workshops, with essentially the same employees and the same training centers. The ties to the Margolis system entities continued. On or about June 1981, WEA, in essence, replaced est, a.e.c. Again, substantially all of the est, a.e.c. employees became employees of WEA, substantially all of the operating assets of est, a.e.c. became the assets of WEA, and the operations continued without interruption.

The acquisition by WEA of the operating assets and certain other assets from est, a.e.c. and from certain system entities was accomplished in four phases. The first phase, which took place in June-July 1981, was financed by a loan of $2,200,000 to WEA from Terla, B.V., a system entity, and a loan of $5,000,000 to WEA from Barclays Bank of San Francisco. The Barclays Bank of San Francisco loan was secured by Parallax, a system entity. The proceeds of the loans were then used by WEA to acquire the operating assets from est, a.e.c., to repay a Werner Erhard loan from Barclays Kol, to repay a Werner Erhard loan from Associated Advisors, to acquire certain art works from Alexia, to pay a deposit to Associated Advisors for the auxiliary sloop Sirona, and for a quitclaim from PMSA. Many of the monetary transfers to and from WEA to effectuate these transactions took place on June 1, 1981. The

record also shows that on May 29, 1981, est, a.e.c. transferred $4,657,000 to Welbehagen, B.V. There is also evidence in the record indicating that the original loan from Barclays Kol to Werner Erhard in 1977 or 1978 had been secured by a collateral deposit from a system entity. We also note that the est, a.e.c. stock was held by the Werner Erhard Charitable Settlement and that Alexia was trustee of the Werner Erhard Charitable Settlement. Both the Werner Erhard Charitable Settlement and Alexia were system entities. The following diagram reflects the money movements that were generated in phase one and the results achieved: [see page 104a]

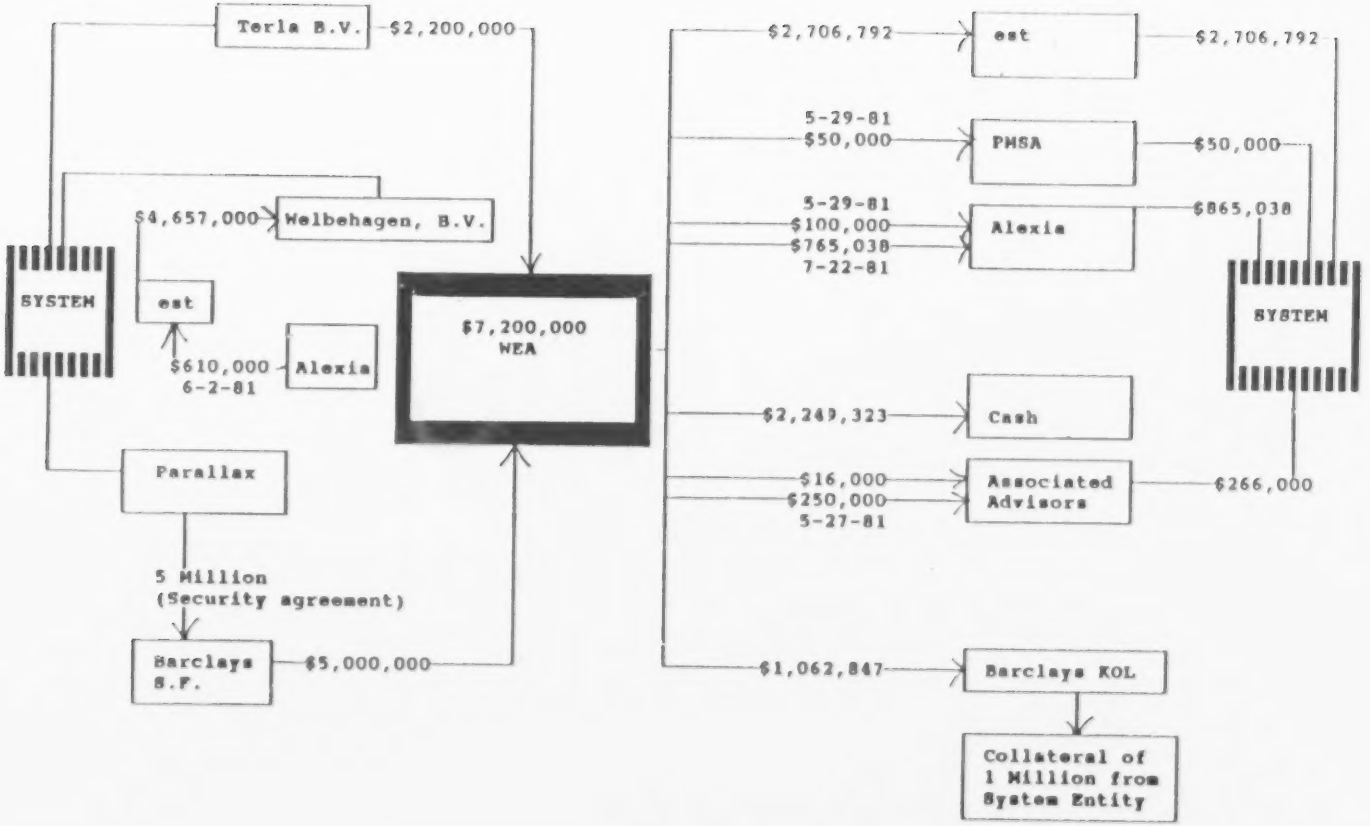
Phase two took place on or about August 27, 1981, and was financed by three separate loans to WEA from Terla, B.V., in the total amount of $6,580,000. The proceeds of these loans were then used by WEA as follows: To est, a.e.c. for adjustments on assets purchased; to Welbehagen, B.V, for the Body of Knowledge; to Antigua Banking Ltd., as repayment for a loan and for the purchase of certain loans; to Associated Advisors for the purchase of the auxiliary sloop Sirona. On August 27, 1981, est, a.e.c. made three transfers to Welbehagen, B.V., in the total amount of $4,571,250. The following diagram reflects the money movements that were generated in phase two and the results achieved: [See page 105a]

Phase three took place on September 15, 1981. After the completion of phases one and two, WEA owed approximately $13,800,000 in short-term debt to Terla, B.V., and Barclays Bank of San Francisco. Phase three was financed with a purported loan of $14,000,000 from Intercultural Cooperation Foundation. The purported source of the loan was Brown Educational Corp., a Margolis controlled entity which at this time had a cash position of less that $1,000. Actually, the $14,000,000 originated with the system entity Sineuri, S.A., (which in turn obtained a much larger transfer from Island

Bank, Ltd.) and then went from Sineuri, S.A., to Brown Educational Corp., to Intercultural Cooperation Foundation, to St. John Fundacion, to the acocunt of WEA at the First National Bank of Boston in Panama (FNBBP). WEA transferred this amount from its FNBBP account to the Island Bank, Ltd. account at FNBBP. Island Bank, Itd. then transferred $8,976,284.95 to Terla, B.V., and $5,023,500 to the WEA account at Barclays Bank of San Francisco. WEA then transferred $5,035,972.23 from its account at Barclays Bank of San Francisco to Barclays Bank of San Francisco. At this point the compensating deposit of $5,000,000 previously made by Parallax as security for the Barclays Bank of San Francisco loan was released. The following diagram reflects the money movements that were generated in phase three and the results achieved: [see page 106a]

The fourth phase took place in December 1981 ostensibly to enable WEA to complete the acquisition of assets from est, a.e.c. The acquisition was financed with a loan to WEA from Intercultural Cooperation Foundation via St. John Fundacion. The source of the $1,000,000 was the Harry E. Wright, Jr., Charitable Trust, an entity effectively controlled by Harry Margolis. The Harry E. Wright, Jr., Charitable Trust obtained the necessary funds for the loan from Antigua Banking, Ltd., and the ABC Trust Co. (both system entities). The money movement was from the Harry E. Wright, Jr., Charitable Trust to Island Bank, Ltd., to Intercultural Cooperation Foundation, to St. John Fundacion, to WEA, to est, a.e.c. In December 1981, WEA also transferred $585,250 to est, a.e.c. for pre-registration bonuses. The following diagram reflects the money movements that were generated in phase four and the results achieved: [see page 107a].

The transactions encountered here illustrate the use of circular money movements and system entities to supplement the Margolis tax-planning. The evidence shows that the money


Terla B.V.
$2,200,000
$4,657,000
Welbehagen, B.V.
SYSTEM
est
$610,000
6-2-81
Alexia
$7,200,000
WEA
Parallax
5 Million
(Security agreement)
Barclays
S.F.
$5,000,000
$2,706,792
est
$2,706,792
5-29-81
$50,000
PMSA
$50,000
5-29-81
$100,000
$765,038
7-22-81
Alexia
$865,038
SYSTEM
$2,249,323
Cash
$16,000
$250,000
5-27-81
Associated
Advisors
$266,000
$1,062,847
Barclays KOL
Collateral of
1 Million from
System Entity

movements were planned in advanced in the Margolis office and collated through the use of documentary authorization forms directing the money flow among the participating entities. Moreover, the record clearly shows that the money movement technique made possible a groups of transactions with a total value far in excess of the actual cash involved. The circular money movements here involved generally began and ended with system entities, with no change in the economic position of the system viewed as a whole. Quite often, the money movements occurred in a single day. The stream of money flowing through the intermediate entities, supported by mere bookkeeping entries or by the devices of back to back loans, was without economic substance. See *Karme v. Commissioner, supra.*

It is established that the economic substance of a transaction, rather than its form, must control for Federal tax purposes. *Gregory v. Helvering*, 293 U.S. 465 (1935); *Zmuda v. Commissioner*, 79 T.C. 714 (1982), aff'd. 731 F.2d 1417 (9th Cir. 1984). In *Falsetti v. Commissioner*, 85 T.C. 332, 347 (1985), we defined "sham in substance" as the expedient of drawing up papers to characterize transactions contrary to economic realities and which have no economic significance beyond tax benefits. The use of the Margolis circular money movement techniques to create the illusion of legitimate transactions has been the focus of attention in a number of cases. See, e.g., *Bail Bonds by Marvin Nelson, Inc. v. Commissioner*, 820 F.2d 1543 (9th Cir. 1987), aff'g. a Memorandum Opinion of this Court; *Karme v. Commissioner*, 73 T.C. 1163 (1980), affd. 673 F.2d 1062 (9th Cir. 1982); *Marine v. Commissioner*, 92 T.C. 958 (1989), aff'd. 921 F.2d 280 (9th Cir. 1991); *Estate of Nazarian v. Commissioner*, T.C. Memo. 1989-179; *Gurdin v. Commissioner*, T.C. Memo. 1987-69; *Erhard Seminars Training v. Commissioner*, T.C. Memo. 1986-526; and *est, An Educational Corporation v. Commissioner*, T.C. Memo. 1986-527.

An examination of the circular money flow in each of the four phases, in which the participation and orchestration by Harry Margolis is amply demonstrated by the record, underscores the complete absence of economic substance sufficient to support the depreciation and interest expense deduction here at issue. In phases one and two the various amounts simply circled out of the system through WEA and back into the system except for cash retained by WEA from the flow in the amount of $2,249,323 in phase one and $850,854 in phase two. Phase three is a unique demonstration of the artificiality of these transactions, notwithstanding the paper trail of documentation generated by the money movement. The ostensible purpose of phase three on September 15, 1981, was to replace the short-term debts purportedly created previously in financing phases one and two. To bolster the legitimacy of the transaction, counsel for petitioner recommended that the financing for the acquisition of the est, a.e.c. assets by WEA should come from a disclosable source. Margolis thereupon obtained the assistance of Wolfgang F. Somary who allowed the Intercultural Cooperation Foundation to serve in the role of lender. Intercultural Cooperation Foundation of course did not have the requisite funds. Again, to assuage the concerns of petitioner's counsel as to the source of the loan, Margolis stated that the amount of $14,000,000 was available from a group of Oklahoma oil investors. Actually, the amount of $14,000,000 originated as part of a money movement from Sineuri, S.A. The flow of funds went from Sineuri, S.A., to Brown Educational Corp., to Intercultural Cooperation Foundation, to St. John Fundacion to WEA. It is significant that the flow of $14,000,000 through Intercultural Cooperation Foundation and St. John Fundacion never left the control of the Margolis system. Margolis associates Everd B. van Walsum and Paul T. Mason acted on behalf of Intercultural Cooperation Foundation and St. John Fundacion, respectively.

WEA then transferred $14,000,000 from its account at FNBBP to the Island Bank, Ltd., account at FNBBP. Island Bank, Ltd., then transferred $8,976,284.95 to Terla, B.V.'s account at FNBBP and $5,023,500 to Barclays Bank of San Francisco. When the Barclays Bank of San Francisco loan was repaid, the compensating deposit of Parallax at Barclays Bank of San Francisco was released and the funds accordingly returned to the Margolis system. All of these orchestrated transactions took place on September 15, 1981. Thus, the Terla, B.V., and Barclays Bank of San Francisco loans which had originated from system funds (directly or indirectly) in phases one and two were repaid with system funds in phase three, and the total amount of such repayments was returned, directly or indirectly, to the system.

The $1,000,000 loan used in phase four by WEA for the purported purchase of final assets from est, a.e.c. followed a similar pattern. Again, the funds originated in a money movement from the Margolis system through the Harry E. Wright, Jr., Charitable Trust, to Island Bank, Ltd., to Intercultural Cooperation Foundation to St. John Fundacion to WEA and from WEA to est, a.e.c.

We conclude, on the basis of the entire record, that WEA did not acquire the est, a.e.c. operating assets as well as the non-operating assets acquired from several other entities in the course of the transactions here involved through bona-fide purchase. We are convinced, and so conclude, that petitioner acquired such assets through sham transactions. We also conclude that the $14,000,000 and $1,000,000 loans purportedly obtained by petitioner to finance the acquisitions were sham transactions completely lacking economic substance and that, consequently, the amounts supposedly paid by petitioner as interest on these loans were not paid on a genuine indebtedness within the meaning of the statute.

We are persuaded that the entire series of events that transpired in 1981 merely represented the so-called "clean-up" phase in which the structure created by Margolis for Werner Erhard in 1975 was shed as a prelude to a new structure. Such periodic restructuring was a feature of the Margolis tax planning for Erhard. Erhard Seminars Training, Inc., was used as the vehicle for the Erhard business operations from 1971 to 1975, at which time it was replaced by est, a.e.c. which in turn was replaced by WEA in 1981. Work on the latest restructuring began on or about May 1980 as a project to "create est anew." The system accounting maintained by the Margolis office was designed to reflect a client's cash position within the system. Consequently, when est, a.e.c. was deemed no longer useful it was imperative for Erhard to ascertain his financial position at that juncture vis-a-vis the system. Investigation of the legal structure of est, a.e.c. was complete in May or June 1980 by legal counsel retained by est, a.e.c. and Erhard. Gary Grace, a former employee of est, a.e.c. and a member of the task team formed to augment the transition process, made an exhaustive investigation of Erhard Seminars Training, Inc., est, a.e.c. and the personal financial status of Erhard for the period 1971-1980 with respect to the Margolis system. It does not appear that any effort was made in the system accounting to differentiate between Werner Erhard and the entities (Erhard Seminars Training, Inc., and est, a.e.c.) which were used to conduct the Erhard business operations over the years.

It then remained for Werner Erhard to remove the operating assets from est, a.e.c., to regain a variety of non-operating assets which had been acquired in the name of various system entities and, in general, to balance accounts with the system. This was accomplished in the transactions which took place for the most part in phases one through four in 1981. Werner Erhard (or WEA) obtained all the business assets needed to

continue his operations. Personal loans owed by Werner Erhard in substantial amounts were repaid. He also acquired possession of art work valued at some $765,038 which had been held in the name of a system entity, the auxiliary sloop Sirona valued at $225,000 which had also been held in the name of a system entity and certain motor vehicles. It also appears that some $3,000,000 remained with Erhard (or WEA) as a result of the circular money movements in phases one and two.

The transactions of 1981 were structured as purchases by Erhard of the various assets at fair market values based upon competent appraisals. However, as the record amply demonstrates, the purported purchases were made possible only by the circular money movements orchestrated by Margolis. The artificial nature of the money movements and the absence of any economic substance in the ephemeral contractual relationships created by such money flows deprives the entire series of transactions of any economic validity. In short, the transactions were illusory in nature.

Petitioner relies upon the testimony of expert witnesses to support the validity of the transactions in 1981. As a rule, we may embrace or reject opinion testimony if, in our best judgment, such action is proper. See *Helvering v. National Grocery Co.*, 304 U.S. 282 (1938). Gilbert T. Schwartz, an attorney, testified as petitioner's expert witness on the subject of banking law and practice. He reviewed the bank records and correspondences relating to the September 15, 1981, transaction and concluded that under customary and ordinary United States banking practice, the $14,000,000 non-negotiable note from Werner Erhard to St. John Fundacion (and then endorsed to ICF) was an enforceable promissory note. Robert Feinerman, a former judge of the California Court of Appeals with some experience in banking matters concluded that both the $14,000,000 and the $1,000,000 non-negotiable notes from Werner Erhard to St. John Fundacion were enforceable under

California law. Peter Hafter, partner in a law firm in Switzerland, also concluded that both notes were enforceable against Werner Erhard in Switzerland. We have considered the opinion testimony of the three expert witnesses as well as their reports. Schwartz examined the background documents, but the full circular flow of the money movement beginning with a system entity, Sineuri, S.A., and effectively ending with system entity is not a part of his analysis. Neither Feinerman nor Hafter, in concluding that the notes executed by Werner Erhard are enforceable, took into consideration the fact the notes were generated as a part of the circular money movements that took place. Each of the witnesses conclude, in essence, that the form of promissory notes was correct and hence they were enforceable and, further, that the various steps, when viewed in isolation, did not deviate from customary and normal banking procedures. We believe that such heavy emphasis on the *form* of the documents involved dispels the effectiveness of the conclusions reached. In short, we find them unpersuasive in the factual context of this case.

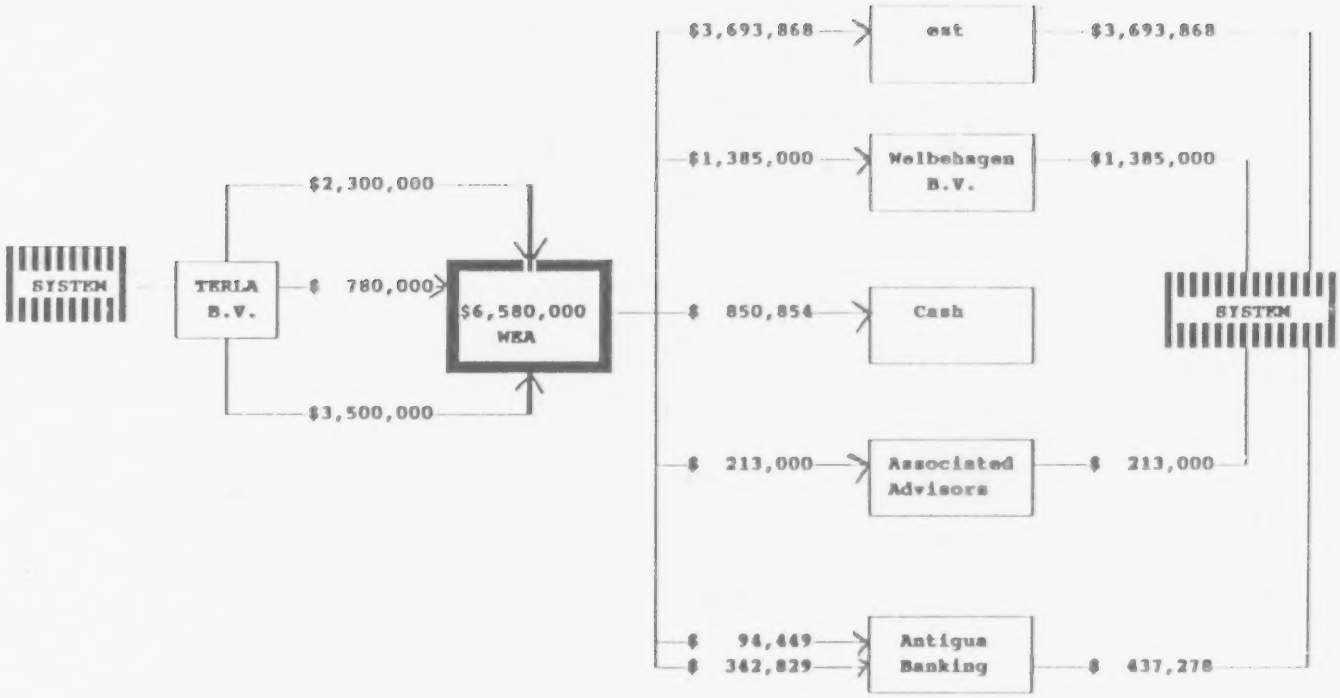
We have also considered the testimony of Anthony V. Langone, who testified as an expert witness for petitioner. Langone prepared a source and application of funds analysis of the cash receipts and disbursements of both Erhard Serminars Training, Inc., and est, a.e.c. covering a total period of some 10 years (1971 through May 30, 1981). He concluded, inter alia, that the source of the two loans in 1981 to Werner Erhard in the total amount of $15,000,000 was neither Erhard Seminars Training, Inc., nor est, a.e.c. We give little weight to this opinion testimony. In preparing his analysis, Langone relied upon tax returns filed by the two entities as well as accounting records of other related entities. In *Erhard Seminars Training v. Commissioner*, T.C. Memo. 1986-526, and in *est, An Educational Corporation*, T.C. Memo. 1986-527, this Court concluded that the taxpayers engaged in sham transactions

during the years covered by the Langone analysis, and we consequently disallowed deductions in substantial amounts for numerous items which were created by the sham transactions. Since the analysis prepared by Langone rests in large part on the purported accuracy of the returns and related records of the two entities, we deem his analysis seriously flawed. We have examined the report, with the accompanying exhibits, and we are unable to agree with the conclusions reached.

Petitioner contends that the decision to shed est, a.e.c. in 1981 and continue the Erhard operations as Werner Erhard & Associates, a sole proprietorship, was prompted by business realities and that the transactions between WEA and est, a.e.c., as well as the financial obligations purportedly incurred, were thus valid and should be given effect for tax purposes. The business reality, argues petitioners, was to escape the perceived financial damage to the enterprise caused by the continued association of the enterprise with Margolis. Petitioner also contends that continued association with Margolis was detrimental to the public image of the enterprise. We do not find such argument convincing. Apart from generalities, there is little evidence in the record to document this perceived adverse effect to the enterprise cause by Margolis. Moreover, even if the avowed purpose was to obliterate the Margolis connection, the record establishes that this did not occur. Quite the opposite, Margolis continued to play a significant role in the affairs of WEA, the new entity. He orchestrated the circular money movements that served as a vehicle for the transfer of both operating and non-operating assets to WEA in the form of purchase agreements. The Margolis money movements also generated, directly or indirectly, the loans used to finance the purported purchase transactions. The deductions claimed by the WEA operation during the years here involved are inextricably linked to these events.

In view of the Margolis penchant for periodically shedding

the entities used to conduct the Werner Erhard enterprises and continuing the operations largely unchanged in some new form with substantially the same personnel, the readily available web of Margolis system entities to shield the true ownership of assets that in reality belonged to the Werner Erhard operation, and the use of the parallel system of system accounting used to monitor the cash position of Werner Erhard vis-a-vis the system, regardless of which entity was currently conducting the Erhard operation make it difficult to accept petitioner's version of the reasons that prompted the 1981 transfer of assets from est, a.e.c. to WEA. We believe that est, a.e.c. was in effect terminated as originally contemplated in 1975, a financial accounting was rendered for Werner Erhard covering some 10 years of close involvement with the system and its entities, and the assets transferred to Werner Erhard in an artificial series of transactions that produced the depreciation expense deductions in 1981, 1982, and 1983 in the respective amounts of $884,024, $1,471,211, and $1,332,998 and interest expense deductions in the respective amounts of $227,951, $300,000, and $300,000. We conclude that the circular money movements were shams designed to simulate the transactions here involved. We further conclude that the purported purchase transactions and loans, both short-term and long-term, were artificial transactions lacking any business purpose and were without economic substance and, consequently, will be disregarded. We hold, on this record, that petitioner is not entitled to the depreciation expense deductions under section 167(a) and the interest expense deduction claimed under section 163(a). In short, there is nothing in this record that would permit a finding of any basis for any of the assets in the hands of WEA. Our conclusion that the loans, both short-term and long-term, were sham transactions without economic substance disposes of petitioner's alternative argument that the purported interest payments are deductible under the provisions of section 162(a) as ordinary and necesary business expenses or under section 165 as business losses.


SYSTEM
TERLA B.V.
$2,300,000
$ 780,000
$3,500,000
$6,580,000 WRA
$3,693,868
eat
$3,693,868
$1,385,000
Welbehagen B.V.
$1,385,000
$ 850,854
Cash
$ 213,000
Associated Advisors
$ 213,000
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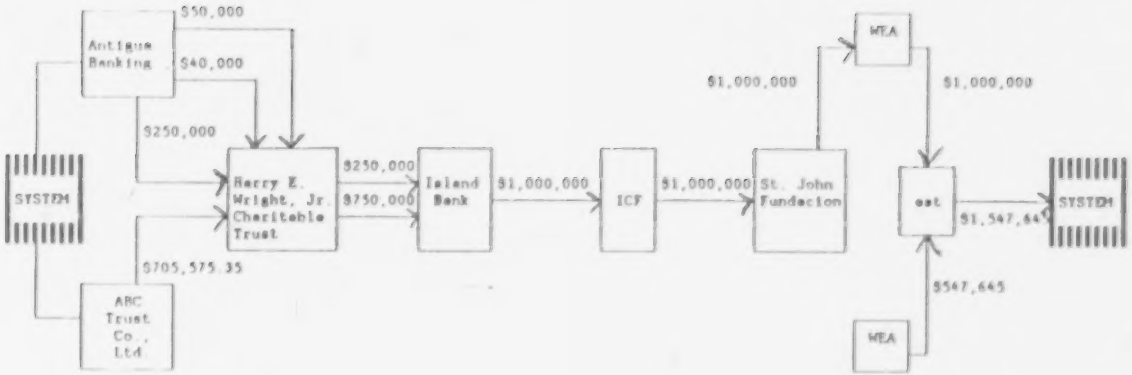
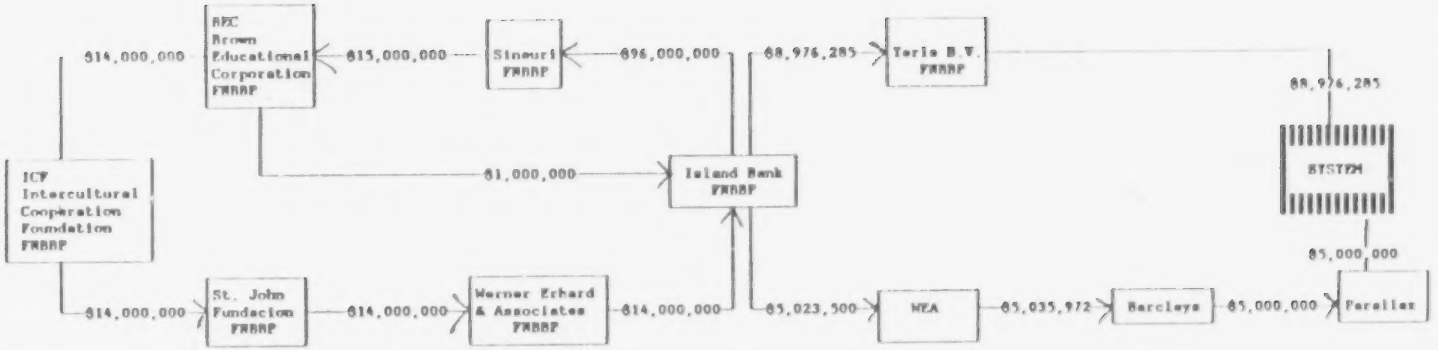
SYSTEM


$50,000
Antigua Banking
$40,000
$250,000
SYSTEM
Harry E. Wright, Jr. Charitable Trust
$250,000
$750,000
Island Bank
$1,000,000
ICF
$1,000,000
St. John Fundacion
$1,000,000
WEA
$1,000,000
eat
$1,547,64
SYSTEM
$705,575.35
ABC Trust Co., Ltd
$547,645
WEA


$14,000,000
RFC
Brown
Educational
Corporation
FNBBP
$15,000,000
Sinouri
FNBBP
$96,000,000
$8,976,285
Yerla B.V.
FNBBP
$8,976,285
SYSTEM
$5,000,000
Parallax
ICF
Intercultural
Cooperation
Foundation
FNBBP
$1,000,000
Island Bank
FNBBP
$14,000,000
St. John
Fundacion
FNBBP
$14,000,000
Werner Erhard
& Associates
FNBBP
$14,000,000
$5,023,500
WEA
$5,035,972
Barclays
$5,000,000

Section 6653(a)(1) imposes an addition to tax equal to five percent of the underpayment of tax if any part of the underpayment is due to negligence or intentional disregard of rules and regulations. Section 6653(a)(2) imposes an addition to tax in the amount of 50 percent of the interest due on the portion of the underpayment attributable to negligence. For the purposes of these sections, negligence is the failure to use due care or to do what a reasonable and ordinarily prudent person would do under the circumstances. *Zmuda v. Commissioner*, 731 F.2d 1417, 1422 (9th Cir. 1984), aff'g. 79 T.C. 714 (1982); *Neely v. Commissioner*, 85 T.C. 934, 947 (1985). Petitioner has the burden of proof on this issue. *Hall v. Commissioner*, 729 F.2d 632, 635 (9th Cir. 1984), aff'g. a Memorandum Opinion of this Court; *Bixby v. Commissioner*, 58 T.C. 757, 791 (1972).

Reasonable reliance by a taxpayer on the advice of an attorney or accountant is sufficient to avoid the addition to tax for negligence. *United States v. Boyle*, 469 U.S. 241, 250 (1985). Such reasonable reliance on professional advice may suffice even if the advice is wrong. *Estate of Paxton v. Commissioner*, 86 T.C. 785, 820 (1986). "Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney." *United States v. Boyle, supra* at 251.

Here, the record shows that competent attorneys and accountants were closely involved in the complex endeavors to transfer the est, a.e.c. assets and the assets held by system entities to Werner Erhard in 1981. The tax professionals involved were for the most part sufficiently informed to be in a position to give competent advice. The attorneys had been involved in the investigation of the est, a.e.c. structure and its link with the Margolis system and were thus familiar with the background of the events in the years preceding the 1981 transactions. A tax partner from a national accounting firm

worked on the schedules pertaining to the WEA operations in petitioner's returns for the years involved. Petitioner was assured by his tax attorneys and the accounting professionals with respect to particulars on his tax returns for the years before us. We have also considered the countervailing strains in the record. An attorney who was closely involved in the investigation of the pre-1981 organizational structure surrounding est, a.e.c. as part of the project to continue the operations in a new form referred to the structure as a "web" and a "swamp." Some of the elements of the maze of entities seemed to defy understanding, and some doubt exists whether the needed information was fully available. Nonetheless, in view of the large role played by competent counsel in this matter, we conclude that petitioner was not negligent or in intentional disregard of rules and regulations. Consequently, we hold that petitioner is not liable for the additions to tax in 1981, 1982, and 1983 under the provisions of section 6653(a)(1) and (2).

With respect to returns filed after December 31, 1982, section 6661(a) imposes an addition to tax on any substantial understatement of income tax. A substantial understatement is one that exceeds the greater of either 10 percent of the tax required to be shown on the return or $5,000. Section 6661(b)(1). The amount of the understatement is reduced if there is substantial authority for the tax treatment of the item at issue (section 6661(b)(2)(B)(i)) or if the relevant facts affecting the items tax treatment are adequately disclosed (section 6661(b)(2)(B)(ii)). There exists no perceivable authority, statutory or otherwise, for the tax treatment claimed by petitioner with respect to the items in dispute. The transactions purporting to support the tax treatment of such items wre illusory and completely devoid of economic substance. See *Karme v. Commissioner, supra.* Moreover, there is no disclosure on the returns of the relevant facts affecting the

tax treatment of the item at issue.

Under section 6661(c), respondent is permitted to waive the addition to tax if the taxpayer shows reasonable cause and good faith regarding the understatement. The most important factor in making a determination regarding waiver of the addition is the extent of the taxpayer's effort to assess his proper tax liability under the law. Sec. 1.6661-6(b), Income Tax Regs. The standard of review in the case of a failure to grant a waiver is whether respondent abused his discretion. *Mailman v. Commissioner*, 91 T.C. 1079, 1084 (1988). On this record we find that respondent did not abuse his discretion in denying a waiver of the addition to tax pursuant to section 6661(c).

Finally, petitioner argues, in effect, that section 6661 should not be applied retroactively to transactions which took place in 1981. Section 6661(a) was originally added to the Code by section 323(a) of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-24, 96 Stat. 324, 613, and was made applicable to returns due after December 31, 1982, (sec. 323 of the act, 96 Stat. at 615). Section 8002(b) of the Omnibus Budget Reconciliation Act of 1986, Pub. L. No. 99-509, 100 Stat. 1874, 1951, increased to 25 percent the addition for substantial understatement, effective for additions assessed after October 21, 1986. Because the addition here will be assessed after that date, the 25-percent rate applies. *Pallottini v. Commissioner*, 90 T.C. 498 (1988). Petitioner's arguments on the applicability of section 6661, as amended, to petitioner's taxable years 1982 and 1983 therefore is without merit.

Section 6621(c) provides for an interest rate of 120 percent of the adjusted rate established under section 6601 if there is a "substantial underpayment" (an underpayment which exceeds $1,000) in any taxable year attributable to one or more

"tax motivated transactions." The increased rate applies to interest accrued after December 31, 1984, even though the transaction was entered into prior to that date. *Solowiejczyk v. Commissioner*, 85 T.C. 552 (1985), aff'd. without published opinion 795 F.2d 1005 (2nd Cir. 1986). Among the transactions enumerated in the statute as "tax motivated" is "any sham or fraudulent transaction." Sec. 6621(c)(A)(v). Since we conclude on this record that the transactions herein involved represented factual shams, we hold that section 6621(c) is applicable. Respondent is sustained.

Decisions will be
entered under Rule 155.

APPENDIX G

UNITED STATES TAX COURT
WASHINGTON, D.C. 20217

WERNER H. ERHARD AND ELLEN V. ERHARD, Petitioners,	
v.	Docket No. 39473-85
COMMISSIONER OF INTERNAL REVENUE, Respondent.	

ORDER

At the hearing held before this Court in New York, New York on August 17, 1988 petitioner Werner H. Erhard presented an oral motion pursuant to 28 U.S.C. § 455(a) requesting the Special Trial Judge assigned to this case by the Chief Judge of the United States Tax Court to disqualify himself from presiding over further proceedings in this case on the grounds that his impartiality might be questioned. Memoranda of law have been filed by the parties addressed to said motion.

A previous motion filed with this Court by Petitioners in the above-captioned case requesting the Chief Judge of the Court to reassign this case to a Judge of the Court was denied on February 24, 1988. In denying said motion the Court considered, inter alia, the petitioners' position that the Special Trial Judge assigned to this case would be prejudiced against petitioner in view of the fact that he had previously heard testimony of petitioner Werner H. Erhard in other cases assigned to him. See *Erhard Seminars Training v. Commissioner*, T.C. Memo. 1986-576 (1986); and *est. An Educational Corporation v. Commissioner*, T.C. Memo. 1986-527 (1986). A motion for reconsideration filed by petitioner Werner H. Erhard was denied by this Court on March 10, 1988.

We have carefully considered the contentions of the parties with respect to the pending oral motion pursuant to 28 U.S.C. § 455(a) which provides: "Any justice, judge or magistrate of the United States shall disqualify himself in any proceeding in which his impartiality might reasonably be questioned." We have also considered the recent decision of *Liljeberg v. Health Services Acquisition Corp.* ____ U.S. ____ (June 17, 1988), 108 S. Ct. 2194 in which the Supreme Court considered the construction to be given to the provisions of 28 U.S.C. §455(a). We believe that petitioner's effort to expand the application of 28 U.S.C. §455(a) to the circumstances of this case is wholly unpersuasive. In our view, the *Liljeberg* case does not support the attenuated interpretation of the statute argued by the petitioner. Nor do the authorities cited by petitioner support petitioner's contentions with respect to the existence of impartiality within the meaning of 28 U.S.C. §455(a). Upon consideration, it is

ORDERED that the oral motion filed by petitioner Werner H. Erhard on August 17, 1988 requesting the Special Trial Judge assigned to this case to disqualify himself from presiding over this case is denied.

(Signed) JAMES M. GUSSIS
James M. Gussis
Special Trial Judge

Dated: Washington, D.C.
September 22, 1988.

APPENDIX H

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

WERNER H. ERHARD Petitioner, vs. UNITED STATES TAX COURT Respondent, and COMMISSIONER OF INTERNAL REVENUE SERVICE, et al., Real Parties in Inerest.	)	FILED APR 28 1988 CATHY A CATTERSON CLERK U.S. COURT OF APPEALS No . 88-7110 ORDER

Before: GOODWIN, SCHROEDER, and PREGERSON, Circuit Judges

The petition for a writ of mandamus is denied for failure to show damage not correctable on appeal and for failure to show that tax court clearly erred as a matter of law. *See Bauman v. United States District Court*, 557 F.2d 650, 654-55 (9th Cir. 1977).

MoCal 4/27/88

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APPENDIX I

UNITED STATES TAX COURT
Washington, D.. 20217

WERNER H. ERHARD AND ELLEN V. ERHARD, Petitioners,	)	
v.	)	Docket No. 39473-85
COMMISSIONER OF INTERNAL REVENUE, Respondent.	)	

ORDER

Counsel for petitioner Werner H. Erhard, on February 16, 1988, filed a motion requesting that this case be reassigned from Special Trial Judge James M. Gussis to a judge of the Court. On that same date, a similar motion was filed by counsel for petitioner Ellen V. Erhard.

In support of the motion filed by counsel for petitioner Werner H. Erhard it is asserted that procedures under which a case involving more than $10,000 is processed by a special trial judge is duplicative. In fact the "two-step procedure" referred to in the motion is no longer part of the Court's Rules and has not been since 1984.

The motion further states that a petitioner in a case involving $10,000 or less must consent to the assignment of such case to a special trial judge and in the instant case assignment was made without such consent. In fact the consent by a petitioner in a case involving less than $10,000 relates to the processing of the case in accordance with the small case procedures, irrespective of whether the case is assigned to, or heard by, a special trial judge or a judge.

The Court has also considered petitioners' position that Special Trial Judge Gussis would be prejudiced against petitioners in view of the fact that he had previously heard testimony of the petitioner Werner H. Erhard in other cases assigned to him. This contention ws discussed with Special Trial Judge Gussis and, based upon that conversation, the undersigned is confident that he will be able to hear the matter fairly and without prejudice or bias. Upon due consideration, it is

ORDERED that both petitioner Werner H. Erhard's motion and petitioner Ellen V. Erhard's motion for reassignment of this case from Special Trial Judge James M. Gussis to a judge of the Court is denied. It is further

ORDERED that petitioner Werner H. Erhard's request contained in the motion that this Court certify that the ruling on this motion may be appealed is denied.

(Signed) Samuel B. Sterrett
Samuel B. Sterrett
Chief Judge

Dated: Washington, D.C.
February 24, 1988

Supreme Court, U.S.
FILED
SEP 25 1995
CLERK

No. 95-135

In the Supreme Court of the United States

OCTOBER TERM, 1995

WERNER H. ERHARD, PETITIONER,

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether the Tax Court judge to whom this case was assigned made the decision for the court in this case.

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In the Supreme Court of the United States

OCTOBER TERM, 1995

No. 95-135

WERNER H. ERHARD, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 3a-27a) is reported at 46 F.3d 1470. The opinion of the Tax Court (Pet. App. 49a-119a) is unofficially reported at 62 T.C.M. (CCH) 1. The supplemental memorandum of the Tax Court (Pet. App. 35a-48a) is unofficially reported at 64 T.C.M. (CCH) 10. The second supplemental memorandum opinion of the Tax Court (Pet. App. 30a-34a) is unofficially reported at 65 T.C.M. (CCH) 1786.

JURISDICTION

The judgment of the court of appeals was entered on February 8, 1995. The petition for rehearing was denied on April 25, 1995 (Pet. App. 1a-2a). The petition for a writ of certiorari was filed on July 24, 1995. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. The Commissioner of Internal Revenue determined deficiencies in petitioner's income tax for the years 1981, 1982, and 1983. Additions to tax under Sections 6653(a)(1), 6653(a)(2), and 6661 of the Internal Revenue Code were also asserted (Pet. App. 50a). Petitioner sought review of the asserted deficiencies in the Tax Court. Acting under the authority provided by Section 7443A(b)(4) of the Code, the Chief Judge of the Tax Court assigned the case to Special Trial Judge Gussis for hearing and for preparation of a report (Pet. App. 49a).

At the conclusion of the trial, Special Trial Judge Gussis submitted proposed findings of fact and a proposed opinion to the Chief Judge. The case was then assigned to Tax Court Judge Scott for disposition. On July 1, 1991, Judge Scott formally adopted the special trial judge's proposed findings of fact and opinion (Pet. App. 49a). The opinion sustained the Commissioner's determinations of deficiencies, additions to tax and interest (*id.* at 115a-119a).

2. Petitioner filed a motion for reconsideration in which he contended that, by adopting the special trial judge's report on the same day that it was filed with the court, the Tax Court effectively permitted the special trial judge—rather than the regular Tax Court judge—to decide the case. Petitioner con-

tended that the decision was therefore entered in a manner inconsistent with Section 7443A(c) of the Code, which specifies that cases involving more than $10,000 may be referred to special trial judges for hearing and reports but must be decided by the regular Tax Court judges. See 26 U.S.C. 7443A(c).

At a hearing on petitioner's motion for reconsideration, Judge Scott responded to petitioner's concern (C.A. Excerpts of Record 797):

> That is what the record shows because that is what is done for record-keeping in the Court. * * * The actual case was sent in to me at least five and probably six weeks before July 1 * * * and I did the work I considered necessary on it. * * * I just didn't want to leave any impression that I was able to adopt an opinion like this with one day's work. * * * It obviously is not possible on this one and was not done.

Judge Scott further stated, "I did rely on the Special Trial Judge's findings, although, I didn't just take them carte blanche" (*id.* at 801).

In a supplemental memorandum opinion, the Tax Court reaffirmed its essential conclusions but determined that petitioner was entitled to some of the deductions that he had claimed (Pet. App. 35a-48a). Petitioner and the Commissioner then disagreed about the appropriate computations under Tax Court Rule 155. In a Second Supplemental Memorandum Opinion, the Court adopted the Commissioner's proposed computation (Pet. App. 30a-34a).

3. On appeal, petitioner challenged the merits of the Tax Court decision and argued that the case should be remanded to the Tax Court for further proceedings. In support of the request for a remand,

petitioner claimed that Judge Scott improperly allowed the special trial judge to decide the case.

The court of appeals upheld the Tax Court decision on the merits (Pet. App. 27a) and also rejected petitioner's request for remand (*id.* at 18a). In particular, the court rejected petitioner's claim that the special trial judge was improperly permitted to make the decision of the Tax Court because the parties were not given an opportunity to file objections to the special trial judge's report and recommendations. The court agreed that "permitting the litigants to file objections to the special [trial] judge's report might well decrease the danger that the tax court judge will simply endorse the report without review" (*id.* at. 16a). The court concluded, however, that, "absent such a procedure, the tax court judge will not necessarily abdicate her judicial responsibility" (*id.* at 17a). The court noted that "[t]he Supreme Court has cautioned specifically that '"rubber stamp" activity' on the part of the tax court judge is not to be assumed" (*ibid.*, quoting *Freytag* v. *Commissioner*, 501 U.S. 868, 872 n.2 (1991)).

The court also rejected petitioner's factual contention that Judge Scott did not adequately review the case. The court noted that "Tax Court Rule 183 requires Judge Scott to give 'due regard' to [Special Trial] Judge Gussis' report on findings of facts and credibility" and that "Judge Scott made clear that while she did rely on Judge Gussis' findings, she did not 'take them carte blanche'" (Pet. App. 17a). The court observed that petitioner pointed to "isolated mistakes" made by Judge Scott in comments at the hearing on petitioner's motion for reconsideration but that "the few errors Judge Scott did make were understandable in light of the case's enormous

complexity" (*id.* at 17a-18a). The court concluded that "Judge Scott's other comments indicate a satisfactory understanding of the case" (*id.* at 17a) and that, "[a]fter carefully examining the record and Judge Scott's comments, we are convinced that Judge Scott's review of the case was adequate" (*ibid.*).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. Section 7443A of the Internal Revenue Code authorizes the Chief Judge of the Tax Court to appoint special trial judges and to assign certain types of cases to them for hearing and adjudication. Under Sections 7443A(c) and 7459(a), however, only a regular Tax Court judge, and not a special trial judge, may decide a case that is assigned to a special trial judge for hearing under Section 7443A(b)(4). In particular, although a case involving more than $10,000 may be assigned to a special trial judge for hearing under 26 U.S.C. 7443A(b)(4), only a regular Tax Court judge may decide such a case.

For cases involving more than $10,000, Tax Court Rule 183(c) provides:

> The Division to which the case is assigned may adopt the Special Trial Judge's report or may modify it or may reject it in whole or in part, or may direct the filing of additional briefs or may receive further evidence or may direct oral argument, or may recommit the report with instructions. Due regard shall be given to the circumstance that the Special Trial Judge had the opportunity to evaluate the credibility of

> witnesses, and the findings of fact recommended by the Special Trial Judge shall be presumed to be correct.

Petitioner asserts that the "requirement that the Tax Court judge decide the case cannot be met if a deferential standard, and certainly not if a clear error standard of review, is used" (Pet. 11). The Fifth Circuit rejected that argument, however, in *Freytag* v. *Commissioner*, 904 F.2d 1011, 1015 (1990), aff'd, 501 U.S. 868 (1991). In *Freytag*, the court of appeals stated that "[o]ur analysis begins and ends with the simple fact that the opinion in this case was issued by the Tax Court in the name of the chief judge. The chief judge had both the obligation and power to maintain full responsibility for the decision in this case." 904 F.2d at 1015. The court further noted that, "[a]lthough Tax Court Rule 183(c) indicates that the special trial judge's recommended findings of fact shall be presumed correct, it is the division of the Tax Court to which the case is formally assigned that controls the outcome of the case." 904 F.2d at 1015 n.8. In affirming the Fifth Circuit's decision in *Freytag*, this Court noted that the argument that the deferential standard of review under Tax Court Rule 183 allows the special trial judge effectively to decide the case was "not relevant to [the] grant of certiorari" (501 U.S. at 874 n.3). The Court nonetheless observed that "under § 7443A(c) a special trial judge has no authority to decide a case assigned under subsection (b)(4)." 501 U.S. at 875 n.3.

Petitioner fails to recognize that Tax Court Rule 183 does not limit Tax Court judges to review of a special trial judge's report for "clear error." Instead, Rule 183 provides that the Tax Court judge respon-

sible for deciding a case may adopt, modify, or reject the special trial judge's report in whole or in part, may request additional briefing, and "may receive further evidence." That authority obviously differs from "clear error" review, under which an appellate tribunal reviews findings of fact merely to determine whether the record permits the conclusions that the fact-finder reached. See *Anderson* v. *City of Bessemer City*, 470 U.S. 564, 573-574 (1985).

Petitioner relies (at Pet. 11-14) upon the last sentence of Rule 183, which states that "[d]ue regard" shall be given to credibility determinations of the special trial judges and that "findings of fact recommended by the Special Trial Judge shall be presumed to be correct." The last sentence of Rule 183, however, does not limit the regular Tax Court judge deciding the case to "clear error" review, and has not been so understood by the Tax Court. In *Rosenbaum* v. *Commissioner*, 45 T.C.M. (CCH) 825 (1983), rev'd *sub nom. Stone* v. *Commissioner*, 865 F.2d 342 (D.C. Cir. 1989), the Tax Court held that "the presumptive correctness of the Special Trial Judge's report does not impair nor dilute our duty of bearing the ultimate responsibility for determining matters before us." 45 T.C.M. (CCH) at 827. Although the United States Court of Appeals for the District of Columbia Circuit in *Stone* stated that the "presumption of correctness" under Rule 183(c) indicates a "relatively high level of deference" which the court analogized to "clearly erroneous" review (865 F.2d at 344), the Tax Court has never acquiesced in that view and has not retreated from the position it took in *Rosenbaum*.

Since 1984, the Tax Court has declined to furnish a copy of the special trial judge's report to litigants

and does not routinely invite the parties to file exceptions to that report.[1] As the Fifth Circuit stated in *Freytag* v. *Commissioner*, 904 F.2d at 1015 n.8, "this change in rules, in our view, confirms that the Tax Court's relationship with its special trial judges cannot be analogized to typical appellate review."

The fact that Rule 183(c) provides that "[d]ue regard" should be given to the special trial judge's credibility determinations and that his findings of fact shall be "presumed to be correct" does not impede the independence of the decision made by the regular Tax Court judge assigned to the case. The Rule requires the regular judge to start with the facts found by the special trial judge before considering the parties' proposed findings of "essential fact" under Tax Court Rule 151(e)(3). That practice is similar to the practice followed by this Court in cases where Special Masters are appointed (*Colorado* v. *New Mexico*, 467 U.S. 310, 317 (1984)):

> Though the Master's findings on these issues deserve respect and a tacit presumption of correctness, the ultimate responsibility for

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[1] Prior to 1984, Tax Court Rule 182(b) provided for service of a copy of a special trial judge's report on each party at the time of the filing of the report with the court, and Rule 182(c) expressly permitted a party to file exceptions to the report within 45 days. See Amendments to Rules of Practice and Procedure of the United States Tax Court, 71 T.C. 1177, 1214 (effective May 1, 1979). In 1984, Rule 182 was redesignated as the current Rule 183, and the provisions for service of the special trial judge's report and the filing of exceptions were deleted. See Amendments to Rules of Practice and Procedure of the United States Tax Court, 81 T.C. 1043, 1069-1070 (effective Jan. 16, 1984).

> deciding what are correct findings of fact remains with us.

As the Fifth Circuit correctly concluded in *Freytag*, notwithstanding the "presumption of correctness," the Tax Court judge to whom the case is assigned "controls the outcome of the case." 904 F.2d at 1015 n.8.

2. Petitioner argues that Section 7443A of the Code and this Court's decision in *Freytag* v. *Commissioner* require (i) that Tax Court litigants have an opportunity to file objections to the special trial judge's report and (ii) that the Tax Court judge to whom the case is assigned hold a hearing on the objections "under procedures similar to those provided in the Federal Rules of Civil Procedure for the district court review of special master and magistrate reports" (Pet. 14). Rule 183 itself, of course, does not contemplate the filing of objections to the report. The Rule does provide, however, that the Tax Court judge may "adopt the Special Trial Judge's report or may modify it or may reject it in whole or in part, or may direct the filing of additional briefs or may receive further evidence or may direct oral argument, or may recommit the report with instructions."

It has long been recognized that the Tax Court has the inherent right "to make reasonable rules of pleading and practice for the orderly hearing and determination of cases before it" (*Given* v. *Commissioner*, 238 F.2d 579, 583 (8th Cir. 1956)). See also *Louisville Builders Supply Co.* v. *Commissioner*, 294 F.2d 333, 339 (6th Cir. 1961). "The Tax Court is of course free to make its own rules determining the relation between it and its Special

Trial Judges." *Stone* v. *Commissioner*, 865 F.2d at 347. As the court of appeals noted, "permitting the litigants to file objections to the special [trial] judge's report might well decrease the danger that the tax court judge will simply endorse the report without review" (Pet. App. 16a). But " 'rubber stamp' activity" on the part of the Tax Court judge assigned to the case is not to be presumed. *Freytag* v. *Commissioner*, 501 U.S. at 872 n.2. Thus, even though the Tax Court does not apply procedures identical to those applied in federal district court in reviewing reports of special masters and magistrates, there is no basis for assuming that a Tax Court judge will "abdicate her judicial responsibility" (Pet. App. 17a).

In this case, the record establishes that Judge Scott conducted a thorough, independent review of the record and the law and that she, and not Special Trial Judge Gussis, decided this case. Judge Scott stated in open court that she reviewed all of the relevant testimony and documents and that she did not blindly adopt the findings of the Special Trial Judge or give them "carte blanche" (Pet. App. 17a).[2] It was only

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[2] Petitioner erred below in assuming that Judge Scott entered her opinion on the same day that the special trial judge forwarded the recommended opinion. As Judge Scott explained, the recommended opinion was submitted to her, along with the balance of the file of the case, several weeks before she issued her opinion in this case. See page 3, *supra*. In *Freytag* v. *Commissioner*, 501 U.S. at 872 n.2, the taxpayer also "place[d] some emphasis" on the fact that the Tax Court appeared to have adopted the report of the special trial judge on the same day that it was filed with the court. As this Court stated, however, "this chronology does not appear to us to be at all significant. * * * The burden of proof as to any negative

after a thorough and independent review of the record and applicable law that Judge Scott adopted and entered the proposed opinion as her own (Pet. App. 49a).

It is also obvious that petitioner had ample opportunity to make his position known to the Tax Court judge assigned to this case. Petitioner filed a 283-page opening brief, a 321-page reply brief, and a 141-page surreply brief to guide the court in its factual findings and legal conclusions. Petitioner's briefs, along with the entire record of the case, were submitted to Judge Scott when the case was assigned to her for disposition. In addition, petitioner had the opportunity to file, and did file, motions for reconsideration and to vacate the decision. Those motions were considered and ruled upon by Judge Scott.

Because Judge Scott made a thorough, independent review of the record and applicable law, because petitioner had ample opportunity to address the issues to the court and to make its position known, and because Judge Scott (rather than the special trial judge) made the final decision in this case, the court of appeals correctly concluded that there was no reason to remand the case to the Tax Court (Pet. App. 18a). Petitioner acknowledges (Pet. 10) that the decision of the court of appeals in this case does not conflict with any other decision.

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inference to be drawn from the time factor rests on petitioners. We are not inclined to assume 'rubber stamp' activity on the part of the Chief Judge." *Ibid.*

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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SEPTEMBER 1995

(3)

Supreme Court, U.S.
FILED
OCT 4 1995
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No. 95-135

IN THE

Supreme Court of the United States

OCTOBER TERM, 1995

WERNER H. ERHARD,

Petitioner,

-against-

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

REPLY BRIEF FOR PETITIONER

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IN THE

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-against-

COMMISSIONER OF INTERNAL REVENUE,

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ON PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
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REPLY BRIEF FOR PETITIONER

ARGUMENT

Respondent argues that this case is not appropriate for the grant of certiorari because the Tax Court judge's review of the special trial judge's report was sufficient to satisfy the requirement of I.R.C. § 7443A(b)(4) that the Tax Court judge, and not the special trial judge, actually decide the case. Because the grounds upon which respondent relies have been raised for the first time by respondent's brief, petitioner submits this reply in further support of his petition for certiorari. This case is appropriate for the grant of certiorari because petitioner has asked this Court to consider a question which it specifically declined to answer in *Freytag v. Commissioner*, 501 U.S. 868 (1991). That question is whether the "deferential

standard with which Tax Court Rule 183 requires a Tax Court judge to review the factual findings of a special trial judge allows the latter not only to hear a case but effectively to resolve it." 501 U.S. at 874 n.3. The issue left unanswered in *Freytag* is squarely raised in this case.

I. Failure of the Supreme Court to Consider This Issue Now Will Inevitably Result in Uncertainty in Cases Referred to Special Trial Judges in the Tax Court.

There are currently no conflicting circuit court decisions on the question of whether the deferential standard of review set forth in Tax Court Rule 183 is sufficient to satisfy the requirement of I.R.C. § 7443A(b)(4) that the decision of the Tax Court be rendered by a Tax Court judge and not by a special trial judge. Respondent states that the Tax Court's interpretation of "due regard" requires a less deferential standard of review than "clearly erroneous" (Resp. Obj. 7). However, the District of Columbia Circuit has held that the "due regard" standard set forth in Tax Court Rule 183 is synonymous with a "clearly erroneous" standard of review. *Stone v. Commissioner*, 865 F.2d 342 (D.C. Cir. 1989), *rev'g sub nom. Rosenbaum v. Commissioner*, 45 T.C.M. (CCH) 825, 827 (1983). The Ninth Circuit below similarly stated: "the tax court judge . . . must presume that the special trial judge's findings of fact are correct." Appendix 16a. Accordingly, the Court should grant certiorari in this case now before further uncertainty arises in the standard to be applied by Tax Court judges in reviewing special trial judges' reports. "[T]he time to put on the roof is before it starts raining." *Carolina Environmental Study Group, Inc. v. United States Atomic Energy Comm.*, 431 F. Supp. 203, 226 (W.D.N.C. 1977), *rev'd on other grounds*, 438 U.S. 59 (1978).

II. Tax Court Rule 183 Fails to Provide for the Meaningful Review Required by I.R.C. § 7443A.

Every case assigned to a special trial judge raises the issue of whether Tax Court Rule 183 is consistent with the authorizing statute, I.R.C. § 7443A(b)(4). Tax Court Rule 183 prevents a Tax Court judge from conducting a meaningful review because it requires the Tax Court judge to give "due regard" to a special trial judge's factual findings. As the D.C. Circuit in *Stone* held, due regard is synonymous with a clearly erroneous standard of review. *Stone, supra,* at 346. The circuit court interpretation is consistent with the general standard of review of findings made by a subordinate judicial officer who hears testimony and decides disputed issues of fact. *See* Fed. R. Civ. P. 52(a) and 53(e) (review of master's findings under clearly erroneous standard).[1] The due regard that a Tax Court judge gives to a special trial judge's findings precludes the judge from deciding the case, violating I.R.C. § 7443A and the principles of *Freytag*.

Respondent asserts that the Tax Court has an "inherent right" to make reasonable rules regarding the hearing and determination of cases before it, and refers to a list of "opportunities" and proceedings in the Tax Court as proof that there was no "rubber stamp activity" on the part of the Tax Court judge (Resp. Obj. 10-11). Respondent's argument is incorrect and beside the point. The "inherent right" of the Tax Court to make reasonable rules does not give the Tax Court the right to delegate decision-making to special trial judges. The issue raised in this petition is whether the judge's deferen-

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[1]The clearly erroneous review of a master's findings is based on Former Federal Equity Rule 60-1/2, which provided that "the report of the master shall be treated as presumptively correct." Notes of Advisory Committee on Rules, Note to Subdivision (e) (standard for district court review of master's findings "contains in substance the former equity procedure for the review of a master's report").

tial standard of review of the special trial judge's findings is consistent with I.R.C. § 7443A and *Freytag*. None of the "opportunities" (*e.g.*, post-trial briefs submitted to the special trial judge or the filing of a motion for reconsideration) that respondent claims were available to petitioner cures this defect in Tax Court procedure.[2] The Tax Court rules' requirement that due regard be given to a special trial judge's report and the absence of an opportunity for parties to file objections to the spcial trial judge's report eliminates the opportunity for any meaningful review of a special trial judge's factual findings. Therefore, the procedures that Judge Scott and all other Tax Court judges follow do not comply with *Freytag* and the statutory mandate.

CONCLUSION

The petition for a writ of *certiorari* should be granted.

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Respectfully submitted,

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[2]Judge Scott actually complained that petitioner's motion for reconsideration asked Judge Scott to reconsider the special trial judge's factual determinations. 64 T.C.M. (CCH) 1011 (1992).